

# **REGULATORY CONVERGENCE IN EU SECURITIES REGULATION**

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Doctor of Philosophy  
at the University of Leicester**

**by**

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## **Regulatory Convergence in EU Securities Regulation**

**Iris H-Y Chiu**

### **Abstract**

The aim of the thesis is to map out and critically discuss the very recent phenomenon of “regulatory convergence” in EU securities regulation. “Regulatory convergence” is a new development in EU governance in financial services and markets regulation following the Financial Services Action Plan 1999 and the Lamfalussy Report of 2001. Regulatory convergence has 2 aspects, i.e. “regulatory” and “convergence”. The thesis suggests that the “regulatory” aspect may be looked at in 4 parts, namely the source of regulation, the administration of regulation, the supervision of regulation, and the enforcement of the regulation. The thesis maps out and critically discusses each area of regulatory convergence in EU securities regulation, and the methodologies employed by policy and law-makers in securing convergence, which include EU legislation, Commission legislation and “soft law” produced by the Committee of European Securities Regulators. In particular, a cybernetic model of analysis is applied to discuss each aspect of regulation, and the methodologies used in securing “convergence”. The application of the cybernetic model of analysis to the 4 aspects of regulatory convergence allows the drawing of some conclusions about the prospects of regulatory convergence. The thesis also examines whether and to what extent, there is an EU level regulatory system for EU securities regulation, and in the absence of such an EU level system for securities regulation, what forces or incentives would induce Member States to adopt divergent national regulation. The final chapter of the thesis explores theoretical frameworks in organisation theory to suggest how creating an EU agency for securities regulation may address the deficits in the current framework for securing regulatory convergence and lead the way forward to a cybernetically sufficient system for regulatory convergence in EU securities regulation.

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## **LIST OF ABBREVIATIONS**

<b>CESR</b>	<b>Committee of European Securities Regulators</b>
<b>EC</b>	<b>European Communities</b>
<b>ECB</b>	<b>European Central Bank</b>
<b>ECHR</b>	<b>European Convention on Human Rights</b>
<b>ESCB</b>	<b>European System of Central Banks</b>
<b>EU</b>	<b>European Union</b>
<b>FSA</b>	<b>Financial Services Authority</b>
<b>FSAP</b>	<b>Financial Services Action Plan</b>
<b>IDD</b>	<b>Insider Dealing Directive</b>
<b>IOSCO</b>	<b>International Organisation of Securities Commissions</b>
<b>ISD</b>	<b>Investment Services Directive</b>
<b>MIFID</b>	<b>Markets in Financial Instruments Directive</b>
<b>MTF</b>	<b>Multi-lateral Trading Facility</b>
<b>OAM</b>	<b>Officially Appointed Mechanism</b>
<b>Regulation FD</b>	<b>Regulation Fair Disclosure</b>
<b>SEC</b>	<b>Securities Exchange Commission</b>

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Case 32/84, *Van Gend en Loos v Nederlandse Belastingadministratie* [1964] CMLR 423

Case 120/78, *Cassis De Dijon, Rewe-Zentral AG V Bundesmonopolverwaltung fur Branntwein* [1979] ECR 649; [1979] CMLR 49

Case 203/80, *Casati* [1981] E.C.R. 2595

Case 283/81, *Srl CILFIT and Lanificio di Gavardo SpA v Ministry of Health* [1982] E.C.R. 3415

Case 14/83, *Sabine van Colson and Elisabeth Kamaan v Land Nordrhein-Westfalen* [1984] ECR. 1891

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Case C-415/93, *Reference for a preliminary ruling from the Cour d'Appel, Liege, by judgment of that court of 1 October 1993 in the case of Union royale belge des sociétés de football association Asbl and Others v. Jean-Marc Bosman and Others* [1995] ECR. I-4921

*Case C-24/95, Judgment of the Court of 20 March 1997 in Case C-24/95 (reference for a preliminary ruling from the Bundesverwaltungsgericht): Land Rheinland-Pfalz v. Alcan Deutschland GmbH, in the presence of the Oberbundesanwalt beim Bundesverwaltungsgericht [1997] ECR I-1591*

*Case 212/97, Centros Ltd. v. Erhvervs- og Selskabsstyrelsen [1999] 2 CMLR 551*

*Case C-376/98, Germany v European Parliament [2000] ECR I-8419*

*Case C-176/03, Commission v Council, (ECJ, September 13, 2005)*

*Case T-464/04, Independent Music Publishers and Labels Association (Impala, International Association) v. Commission of the European Communities, (Bertelsmann Ag and Others, intervening) [2006] 5 CMLR 19*

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### **UK Legislation**

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#### **Prospectus Regulations 2005**

-section      5(7)

### **European Communities Legislation**

Council Directive 79/279/EEC, co-ordinating the conditions for the admission of securities to official stock exchange listing), OJ L 66 (16/03/1979)

Council Directive 80/390/EEC of 17 March 1980 coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing OJ 1980 L100/1.

Council Directive 82/121/EEC of 15 February 1982 on information to be published on a regular basis by companies the shares of which have been admitted to official stock-exchange listing OJ 1982 L48/26.

Consolidated Council Directive of 20 Dec 1985, on the coordination of laws, regulations and administrative provisions relating to undertakings in collective investment in transferable securities 85/611/EEC (UCITS Directive)

Council Directive 89/298/EEC of 17 April 1989 coordinating the requirements for the drawing-up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public OJ 1989 L124/8

Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing OJ 1989 L334/30

Council Regulation 4064/89, On the Control of Concentrations Between Undertakings, 1989 OJ L 395

Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field OJ 1993 L141/27.

Council Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes OJ 1997 L84/22

Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE) OJ 2001 L294/1

Council Regulation 1/2003 of December 16, 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the EC Treaty, O.J. 2003 L1/1

**Council Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) OJ 2003 L96/16**

**Regulation (EC) No 1725/2003 adopting certain international accounting standards in accordance with Regulation (EC) No. 1606/2002**

**Council Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (Text with EEA relevance) OJ 2003 L345/64**

**Commission Directive 2003/124/EC implementing Directive 2003/6/EC of the European Parliament and Council as regards the definition and public disclosure of inside information and the definition of market manipulation**

**Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest**

**Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments**

**Council Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC OJ 2004 L145/1**

**Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices**

**Council Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC OJ 2004 L390/38**

**Commission Regulation ECNo. 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses**

**Council Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies (Text with EEA relevance) OJ 2005 L310/1**

**Commission Regulation (EC) No 108/2006 of 11 January 2006 amending Regulation (EC) No 1725/2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standards OJ 2006 L24/1**

**Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive OJ 2006 L241/1**

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### **European Treaties**

**Treaty of Amsterdam amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts - Protocol annexed to the Treaty of the European Community - Protocol on the application of the principles of subsidiarity and proportionality OJ 1997 C340/10**

**Treaty establishing the European Community (Amsterdam consolidated version) Preamble EC Treaty (Maastricht consolidated version) EEC Treaty, OJ 1997 C340/179**

**Treaty establishing the European Community (Nice consolidated version), OJ 2002 C325/173**

## **Chapter 1**

### **EU Securities Regulation So Far**

#### **1. Introduction**

This thesis intends to examine the nature and implications of “regulatory convergence”, a new phenomenon in EU securities regulation. In order to unpack “regulatory convergence”, the thesis first proceeds with a historical survey of EU securities regulation from the 1960s to date, to examine how the EU moved from selected areas of regulatory direction to minimum harmonisation in the 1990s, and finally to “regulatory convergence” in the new millennium. Chapter 1 provides such a survey to set “regulatory convergence” in context and examines the policy rationale giving rise to it. Chapter 2 then begins the venture into defining what “regulatory convergence” means and its implications in the interpretation, supervision and enforcement of securities regulation in the EU, and the governance of EU securities regulation in general. The coverage of the rest of the chapters in this thesis is described in Part 5 of this chapter.

#### **2. EU Securities Regulation from the 1960s-1990s- A Brief Survey**

The consciousness of the need for EC securities regulation began as early as 1966 in the Segré Report. The Report identified the problems of businesses suffering from a lack of capital opportunities in the public fund-raising sphere, and the investing public not being able to find attractive opportunities on the market.<sup>1</sup> The underdevelopment of European capital markets has implications not only for enterprise growth and job creation, but also implies the

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<sup>1</sup> Report by a Group of Experts Appointed by the EEC Commission, *The Development of a European Capital Market* (1966), at 27.



inefficient use of savings by the investing public, who may enjoy higher returns in capital growth. Thus, the first driving forces behind EC securities regulation intended to facilitate potential economic benefits.<sup>2</sup> The desire to facilitate more capital availability and movement at the EC level, and to create “deep and liquid” capital markets, remains the focus behind EC securities regulation today.<sup>3</sup>

The integration of EU securities markets should be taken against the backdrop of the economic integration of the EU as a whole, based foundationally on the four freedoms in the Treaty of Rome and later, the Single European Act 1992.<sup>4</sup> One of the ideological foundations for economic integration lay in ordoliberalism<sup>5</sup> which supported the creation of an economic “state” or polity. It was also envisaged<sup>6</sup> that integration may be carried out at a technocratic

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<sup>2</sup> Economic research is sceptical that capital account liberalisation would result in growth in an economy. See D Rodrik, “Who Needs Capital Account Convertibility?” in *Princeton Essays in International Finance* 207 (New Jersey: Princeton University Press 1998) at 55. See also J. E. Stiglitz, “Capital Markets Liberalisation, Economic Growth and Instability” (2000) 28(6) *World Development* 1075. But other surveys using developing countries and foreign direct investment data, reported positive long term economic growth, see D. Quinn, “The Correlates of Change in International Financial Regulation” (1997) 91 *American Political Science Review* 531, M.Klein and G. Olivei, “Capital Account Liberalisation, Financial Depth and Economic Growth” (Federal Reserve Bank of Boston Working Paper 99-6, 1999), at <http://ideas.repec.org/p/fip/fedbwp/99-6.html> (accessed July 2006). See also J. Williamson, “Costs and Benefits of Financial Globalisation: Concepts, Evidence and Implications”, in G.R.D. Underhill and X. Zhang (eds), *International Financial Governance Under Stress* (Cambridge: Cambridge University Press 2003) at 41. However, a recent paper predicts that regulatory convergence and financial integration would result in overall growth for the least developed economies in the EU, see L. Guiso, T. Jappelli, M. Padula and M. Pagano, “Financial Market Integration and Economic Growth in the EU” (2004) *Economic Policy* 525.

<sup>3</sup> Financial Services: Building a Framework for Action, COM (1998) 625 1, and Communication on Implementing the Framework For Financial Markets: Action Plan, COM (1999) 232 (hereinafter known as the “FSAP”), as well as its endorsement in the *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets* (15 Feb 2001) (hereinafter known as the Lamfalussy Report). These goals have been reaffirmed by Charlie McCreevy, Commissioner for the Internal Market of the EU, remarks made at the Committee of European Securities Regulators inaugural conference on 6 December 2004, Bourse, Paris.

<sup>4</sup> Economic integration is the *raison d’être* of the EU, affirmed by the Single European Act 1992. However, postmodernists have offered more alternative readings of the Internal Market. J.H. Bergeron suggests that the Internal Market is keeping within it elements of European-ness in origin or content of goods, to reinforce the nation state vis the vis “The Other” and thus, the Internal Market is merely a symbolic myth which buttresses Europe’s Emprise. See “Europe’s Emprise: Symbolic Economy and the Postmodern Condition” in P.Fitzpatrick and J.H. Bergeron (eds), *Europe’s Other: European Law Between Modernity and Postmodernity* (Aldershot: Ashgate 1998) at 67.

<sup>5</sup> C Joerges, “The Law in the Process of Constitutionalising Europe” EUI Working Paper 2002/4, (Florence: European University Institute 2002).

<sup>6</sup> Ernst B. Haas, *The Uniting of Europe: Political, Social and Economic forces 1950-1957* (Stanford: Stanford University Press 1968) Leon N. Lindberg, *The Political Dynamics of European Economic Integration* (Stanford: Stanford University Press 1963); Leon N Lindberg & Stuart A Scheingold, *Europe’s Would-be Polity: Patterns of Change in the European Community* (Englewood Cliffs, N.J.: Prentice Hall 1970).

level towards economic ends, but the pattern of integration has since become more political<sup>7</sup> in the recent years, with a major emphasis on economic matters nonetheless. The economist Balassa's framework of economic integration provides a framework of 5 stages of economic integration. First, the creation of a free trade area, followed by a customs union, then a common market, then economic union, and finally economic integration. The first 3 stages are marked by negative integration,<sup>8</sup> i.e. removal of barriers to entry, non discrimination and mutual recognition of each Member State's laws. Only in the fourth stage would there be some form of positive integration i.e. harmonisation of standards, and the final stage would be centralisation in supranational institutions and economic governance.<sup>9</sup> Jacques Pelkmans<sup>10</sup> has criticised Balassa's framework as being too crude and not reflective of the true development of EU economic integration. Other commentators also observe a mixture of positive and negative integration processes in the economic integration of the EU, arguing that Balassa's stages are not wholly linear in nature.<sup>11</sup> The development of EC securities regulation has hitherto been a gradual process of both positive and negative integration, but the recent reforms seem to return to Balassa by affirming the acceleration of positive integration towards maximum convergence.

The historical development of EU securities regulation will first be discussed. Early securities regulation in the EU focused on positive integration through the adoption of minimum harmonised standards for listed issuers. The assumption seemed to be that listed issuers were

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<sup>7</sup> Andrew Moravcsik, "Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach" (1993) 31 JCMS 473; *The Choice for Europe: Social Purpose and State Power from Messina to Maastricht* 1-18 (Ithaca, N.Y.: Cornell University Press 1998) focuses on EU integration as a political means of furthering state purposes, creating intergovernmental regimes. See also Gary Marks et al., "European Integration from the 1980s: State-Centric v. Multiple-Level Governance" (1996) 34 JCMS 341 arguing that EU integration is political in the opposite sense, i.e. creating a polity to which states would surrender certain powers.

<sup>8</sup> See F. Scharpf, *Governing in Europe* (Oxford: Oxford University Press 1999) which compares the use of negative integration with positive integration.

<sup>9</sup> B Balassa, *The Theory of Economic Integration* (Homewood, Illinois: Irwin 1961), discussed in Jacques Pelkmans, *European Integration: Methods and Economic Analysis* (2<sup>nd</sup> ed, Harlow: Pearson 2001) at chapter 1.  
<sup>10</sup> *ibid.*

<sup>11</sup> A.S. Sweet and T.L. Brunell argue that European integration has been largely achieved by transnational contracting and resolution of triadic disputes through EU dispute adjudication. See "Constructing a Supranational Constitution: Dispute Resolution and Governance in the European Community" (1998) 92 *American Political Science Review* 63.

more likely to seek capital across a number of Member States and thus, a harmonised regime for admission to listing and listing rules was necessary.

The regulation of capital issues on listed markets ignores the fact that much capital fund-raising, particularly by smaller enterprises, may be carried out on unlisted markets. Such capital fund-raising are nonetheless public offers, and so, limiting harmonisation of standards to listed issuers would mean that in general, securities regulation for all issuers was not harmonised, and only listed market entry requirements were harmonised. Second, harmonisation of listing requirements took place in the form of extensive and detailed Directives such as the Admissions Directive,<sup>12</sup> Listing Particulars Directive<sup>13</sup> and Interim Reports Directive<sup>14</sup> for entities listed on traditional exchanges in Europe. Such detailed harmonisation gave rise to the expectation that there would be consistency in interpretation and application, but many problems were still faced in national interpretation and application.<sup>15</sup> Third, work on supporting and accompanying frameworks lagged behind the call for cross-border listing and fund-raising. Such supporting and accompanying frameworks included frameworks for liberalising investment intermediary activities across Europe as well as coordinating the conduct of investment markets on a European level. Other supporting infrastructures may also include a European company law,<sup>16</sup> particularly in the areas of corporate governance and minority shareholder protection, as well as European frameworks for the clearing and settlement of securities transactions,<sup>17</sup> and taxation. Therefore, this phase

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<sup>12</sup> Council Directive 79/279/EEC, co-ordinating the conditions for the admission of securities to official stock exchange listing), OJ L 66 (16/03/1979).

<sup>13</sup> Council Directive 80/390/EEC of 17 March 1980 coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing OJ 1980 L100/1.

<sup>14</sup> Council Directive 82/121/EEC of 15 February 1982 on information to be published on a regular basis by companies the shares of which have been admitted to official stock-exchange listing OJ 1982 L48/26.

<sup>15</sup> See Niamh Moloney, *EC Securities Regulation* (Oxford: Oxford University Press 2003) at 68.

<sup>16</sup> Some progress has been achieved with the Cross Border Mergers Directive, Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies (Text with EEA relevance) OJ 2005 L310/1; and Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE) OJ 2001 L294/1.

<sup>17</sup> Remarks made by Nigel Wicks, Vice Chairman of CRESTCo/ Euroclear, at the CESR inaugural conference, 6 Dec 2004, Paris.

of minimum positive integration in the entry standards of listed markets did not bring about dramatic results in economic integration.

This experimental first phase of EC securities regulation then moved into a second phase.

The second phase attempted to address the aforementioned issue of the lack of supporting and accompanying frameworks. This phase is marked by strengthening negative integration in terms of mutual recognition. The Investment Services Directive<sup>18</sup> was enacted, and that dealt with the authorisation of securities intermediaries and how they could provide cross-border services via the operation of mutual recognition of the approvals granted in each Member State. More positive integration in creating harmonised standards for public offers on unlisted markets,<sup>19</sup> was also carried out. The Public Offers Directive provided a harmonised regime of disclosure regulation for all capital issuers. However, the Directive only set out a general standard of disclosure, and Member States may impose different specific requirements for the prospectuses required to be prepared by issuers. Thus, the Directive did not entail a level playing field in the EU for capital issuers in unlisted markets. Although this phase of securities market integration is still characterised by the predominant goal of pursuing deeper and more liquid European capital markets,<sup>20</sup> the goal still seems to elude the EU.

By the 1990s, it was generally agreed that the internal market for capital fund-raising and investment activity was still far from being complete,<sup>21</sup> and a detailed report and work plan was finally issued by the Financial Services Policy Group, comprising of Ecofin Council ministers, the European Central Bank, and the European Commission to propose action plans needed in order to facilitate the completion of the internal market in capital fund-raising (the

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<sup>18</sup> Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field OJ 1993 L141/27.

<sup>19</sup> Council Directive 89/298/EEC of 17 April 1989 coordinating the requirements for the drawing-up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public OJ 1989 L124/8.

<sup>20</sup> White Paper on Completing the Internal Market, COM(85)310.

<sup>21</sup> See also Pelkmans, *European Integration* (2001) op cit at n9, at chapter 9.

“Financial Services Action Plan” or FSAP).<sup>22</sup> These measures were endorsed in the Lamfalussy Report of 2001.<sup>23</sup> These reform proposals attempt to complete the internal market by way of more and extended harmonisation, emphasising the positive integration aspect of Balassa’s economic integration model. The key to the recent reforms is the acknowledgement that minimum harmonisation and negative integration in securities regulation are insufficient to bring about an integrated securities market and hence, an unprecedented maximum harmonisation or regulatory convergence is set about to occur.<sup>24</sup> This phase proposes to harmonise capital raising requirements, provide a comprehensive regulatory framework for investment services, and a regulatory framework for investment markets. The new securities regulatory framework would address:

- (a) transactional securities regulation, in terms of regulating initial capital issues and to a certain extent, issuers’ obligations vis a vis secondary market transactions;
- (b) intermediary services regulation so that the facilitators of market transactions would be regulated evenly across the EU; and
- (c) market regulation so that the operation and conduct of markets may be regulated.

The reforms are intended to meet the erstwhile goals of completing a deep and liquid securities market, as well as other newly emerged goals of creating strong securities markets of reputational credibility and facilitating a credible investing environment for investor

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<sup>22</sup> At [http://europa.eu.int/comm/internal\\_market/finances/actionplan/index\\_en.htm](http://europa.eu.int/comm/internal_market/finances/actionplan/index_en.htm) (accessed Feb 2006).

<sup>23</sup> *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets* (15 Feb 2001), available at [http://europa.eu.int/comm/internal\\_market/securities/lamfalussy/index\\_en.htm](http://europa.eu.int/comm/internal_market/securities/lamfalussy/index_en.htm) (accessed Feb 2006).

<sup>24</sup> K. Lannoo and M. Levin, “Securities Market Regulation in the EU” (2003) (Research Study Carried out for the Wise Persons’ Committee, Centre for European Policy Studies 2003), available at [http://216.239.51.104/search?q=cache:MDFLRqTml-QJ:www.wise-averties.ca/reports/WPC\\_4.pdf+gros+lannoo+euro+capital&hl=en&ct=clnk&cd=15&client=opera](http://216.239.51.104/search?q=cache:MDFLRqTml-QJ:www.wise-averties.ca/reports/WPC_4.pdf+gros+lannoo+euro+capital&hl=en&ct=clnk&cd=15&client=opera) (accessed Jan 2006).

protection.<sup>25</sup> However, in terms of institutional development in securities regulation, such as having a pan-European agency for securities regulation apart from national regulators, there is no such proposal as yet.<sup>26</sup>

The new securities regulation reforms seems to have adopted the assumption in Balassa's model that positive integration is the way to economic integration, rather than negative integration. Thus, the emphasis is on maximum regulatory convergence in the substantive laws as well as the supervision of regulated entities and enforcement of the laws to be carried out by Member States. This thesis deals with the movement of regulatory convergence in EU securities regulation. I will now discuss the scope of inquiry in this thesis.

### **3. A Sketch of the New Framework for EU Securities Regulation**

The Lamfalussy report identified that the reform of EU securities regulation should head towards regulatory convergence.<sup>27</sup> Regulatory convergence is envisaged to be achieved in the substantive laws and in supervision and enforcement by Member States. The Report also identified the need for constant monitoring to secure the convergence.

Regulatory convergence is unprecedented in EU securities regulation as it envisages securities regulation in all EU Member States to achieve a level of similarity that approximates to uniformity. However, to what extent Member States' laws should achieve uniformity or near-uniformity, is not clearly defined. This thesis suggests that regulatory convergence poses higher expectations for the level of similarity in Member States' laws, than would be under traditional EU legislation promulgated in the form of Directives.

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<sup>25</sup> Moloney, *EC Securities Regulation* (2003) op cit at n15, thinks that the goal of investor protection is not obviously pursued. See HM Treasury, *The EU Financial Services Action Plan: Delivering the FSAP in the UK* (May 2004), para 1.7.

<sup>26</sup> Remarkd in the Lamfalussy report at 95.

<sup>27</sup> Lamfalussy report at 15.

Maximum harmonisation is not a new phenomenon in EU regulatory governance, for example, in consumer protection, the policy is to achieve a high level of common implementation as well.<sup>28</sup> The level of intensity in regulatory harmonisation is likely to vary according to the issue area concerned.

The Committee of European Securities Regulators (“CESR”), which is tasked to oversee the actual outworking of regulatory convergence, defines regulatory convergence as “to establish common approaches and standards in order to facilitate harmonised implementation of EU law”.<sup>29</sup> What is expected of EU securities regulation is not merely that the substantive laws in EU securities regulation Directives be implemented nationally, but that there is a common approach to interpret, administer and enforce the substantive laws. It is still however, unclear if such a common approach means total uniformity.

The traditional approach to national implementation of EU law is that, where Regulations are concerned, they are directly binding on Member States, but where Directives are concerned, only the results of the Directives need to be achieved in an equivalent manner across Member States, and Member States are free to choose the form and method of implementation, including the words of the transposing legislation.<sup>30</sup> Member States are likely to have different national versions of a Directive, but these differences are accepted as part of the Community method, which does not seek uniformity amongst Member States. This is supported by the foundational values of subsidiarity and proportionality. Subsidiarity is a principle that determines whether an issue ought to be undertaken at an EU level or at

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<sup>28</sup> DG Health and Consumer Protection, European Commission, *Consumer Policy Strategy* (2002), at [http://ec.europa.eu/consumers/overview/cons\\_policy/index\\_en.htm](http://ec.europa.eu/consumers/overview/cons_policy/index_en.htm), (accessed July 2006).

<sup>29</sup> See CESR Himalaya Report of 25 Oct 2004, at p5, at [www.cesr-eu.org](http://www.cesr-eu.org) (accessed March 2006). “Supervisory convergence” is defined as “the co-operation of regulators in the performances of their supervisory tasks and obligations under the Directives/Regulations.”

<sup>30</sup> Art 249, Treaty of Rome, and see *Commission v Italy* [1983] IV ECR 3286. See also Ulrich Haltern, “Integration Through Law” in A Wiener and T Diez (eds), *European Integration Theory* (Oxford: Oxford University Press 2004) at 177ff; Christiaan Timmermans, “Community Directives Revisited” [1997] *Yearbook of European Law* 1, argues that Directives do not inherently give rise to convergence.

national level.<sup>31</sup> Proportionality requires that, even if EU level action is taken, such action should be limited to what is necessary and since Member States have regulatory infrastructure to support the administration of EU laws, it may be too overbearing to shift those tasks to a European level.<sup>32</sup>

Regulatory convergence does not appear to intend to achieve the same effect as the traditional approach, as CESR identifies regulatory convergence as unprecedented and as a specific new task for EU securities regulation.<sup>33</sup> This thesis assumes that the level of regulatory convergence sought to be achieved is certainly higher than the traditional implementation approach, and in the following chapters, this thesis will discuss regulatory convergence in 4 main aspects, namely, convergence in sources of law, interpretive convergence, supervisory convergence and enforcement convergence. Chapter 2 will explain why these 4 aspects constitute the total picture of “regulatory convergence” as sought to be achieved in this round of securities regulation reforms.

The pursuit of convergence may be based on a few goals. First, convergence may be argued to produce a race to the top, while regulatory competition may produce a race to the bottom.<sup>34</sup> It may also be imperative to encourage a certain level of convergence<sup>35</sup> so that the level of investor protection offered in different regimes would not be disparate and a generally high level of investor confidence can be maintained.<sup>36</sup> It has also been opined that the

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<sup>31</sup> Christopher Henkel, “The Allocation of Powers in the EU: A Closer Look at the Principle of Subsidiarity” (2002) 20 Berkeley Journal of International Law 359.

<sup>32</sup> Alan Dashwood, “The Relationship Between Member States and the EU/EC” (2004) 22 CMLR 355 and “The Limits of EC Powers” (1996) 21 ELR 113.

<sup>33</sup> CESR Himalaya Report.

<sup>34</sup> Anthony Ogus, “Competition between National Legal Systems: A Contribution of Economic Analysis to Comparative Law” (1999) 48 ICLQ 405, and Jeanne-Mey Sun & Jacques Pelkmans, “Regulatory Competition in the Single Market” (1995) 33 JCMS 67 ; Emiliós Avgouleas, “The Harmonisation of Rules of Conduct in EU Financial Markets: Economic Analysis, Subsidiarity and Investor Protection” (2000) 6 ELJ 72 at 89.

<sup>35</sup> Hanne Søndergaard Birkmose argues that the level of harmonisation pursued in the EU is higher than that needed to overcome the market failures caused by regulatory competition, and is unwarranted, “Regulatory Competition and the European Harmonisation Process” (2006) 17 EBLR 1137.

<sup>36</sup> See generally, Richard L Levesz, “Federalism and Regulation: Some Generalisations” in Daniel C Esty and Damian Geradin (eds), *Regulatory Competition Regulatory Competition and Economic Integration*:



centralisation of regulation improves market integrity and confidence.<sup>37</sup> Further, it has been pointed out that<sup>38</sup> sufficient diversity has existed for a long time in the EU, and such diversity has only served to produce barriers to entry and obstacles to free movement. Hence, it would seem that top-down convergence may be a viable alternative to waiting for divergences to converge among themselves through market forces of regulatory competition. The demands of market forces and private industries favour policy-led convergence or even centralisation because convergence is perceived to entail savings in cost for multiple cross-border activities. Savings in cost have resulted from other harmonisation movements that have taken place from ground –up and top-down levels in the EU, where cross-border transactions feature heavily.<sup>39</sup>

Before embarking on the analysis of convergence, it is apt at this juncture to mention that, a number of commentators<sup>40</sup> have doubted if regulatory integration *per se* would necessarily bring about an integrated market. Convergence is not regarded as an end in itself, and the wider objective is to achieve an integrated capital market in the EU. Markets continue to be fragmented due to taxation differences, lack of integration in the legal infrastructure for clearing and settlement, the negotiability of securities instruments and custodianship, differences in market and social cultures and differences in the extent of market failures

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*Comparative Perspectives* (Oxford: Oxford University Press 2003). This is also referred to in Marc I. Steinberg and Lee E. Michaels, “Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches in Commonality and Reciprocity” (1999) 20 Michigan Journal of International Law 207.

<sup>37</sup> John C Coates IV, “Private vs Political Choice of Securities Regulation: A Political Cost-Benefit Analysis” (2001) 41 Virginia Journal of International Law 531.

<sup>38</sup> Avgouleas, “The Harmonisation” (2000), op cit at n34 at 89.

<sup>39</sup> See Sabine D Selbach, “The Harmonisation of Corporate Taxation and Accounting Standards in the EC and Their Interrelationship” (2003) Connecticut Journal of International Law 523, Allison Dabbs Garrett, “Themes and Variations: The Convergence of Corporate Governance in Major World Markets” (2004) 32 Denver Journal of International Law and Policy 147, see also the EU Corporate Governance Action Plan, that can be found on the European Parliament website, <http://www.europarl.eu.int>. Even private laws such as contract may increasingly be harmonised, see Anne Catherine Hahn, “The Harmonisation of European Private Law Systems and the Role of Comparative Law” (2002) 30 International Journal of Legal Information 265. There is already some harmonisation in some areas of contract law, such as the Unfair Terms in Consumer Contracts Directive, Council Directive 93/13/EEC of 5 April 1993, OJ L 095 , 21/04/1993. See also Mel Kenny, “Globalisation, Interlegality and Europeanised Contract Law” (2003) 21 Pennsylvania State International Law Review 569.

<sup>40</sup> K Alexander, “Establishing a European Securities Regulator: Is the EU an Optimal Economic Area for a Single Securities Regulator?” (2002) Working Paper no.7 Cambridge Endowment for Research in Finance, 2002. See also J.H. Dalhuisen, “Financial Liberalization and Re-regulation” in Mads Andenas and Wulf-Henning Rolf (eds), *Services and Free Movement in EU Law* (Oxford: Oxford University Press 2000).

across jurisdictions and macroeconomic distortions.<sup>41</sup> Therefore, the removal of regulatory barriers *per se* may not be the key to integration. Further, some commentators argue that regulatory integration or “centralisation” should not be viewed as the optimal way to supply regulation, as there are drawbacks to such centralisation. For example, regulatory competition can be stultified.<sup>42</sup> Regulatory competition is the process where different jurisdictions providing different regulatory frameworks compete with each other to become adopted as the choice of law in private transactions. The chief benefit of regulatory competition is aligning the preferences of the regulated to the regulation, and in the process, innovations in regulatory design that may benefit the beneficiaries of regulation can evolve. However, the suitability of regulatory competition in supplying regulation is also highly controversial.<sup>43</sup>

This thesis does not propose to discuss the merits of regulatory competition versus convergence in EU securities regulation in general.<sup>44</sup> That is the wider context in which the inquiry in this thesis is set. The thesis has a more specific inquiry, that is, to examine the implications for regulatory and policy design if regulatory convergence were to be rigorously implemented. These implications in turn feed back into the wider context of whether regulatory convergence *should* be pursued for market integration. This thesis will attempt to define regulatory convergence in terms of four *regulatory* aspects: (1) sources of law, (2) interpretation and administration of the law, (3) supervision of regulated entities and (4)

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<sup>41</sup> Alexander, *ibid*.

<sup>42</sup> Discussion of the pros and cons of regulatory competition can be traced back to W Cary, “Federalism and Corporate Law” (1974) 83 Yale LJ 663; Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law* (1992) 105 Harvard LR 1435, Amir Licht, “Regulatory Arbitrage For Real: International Securities Regulation in a World of Interacting Securities Markets” (1998) 39 Virginia Journal of International Law 563. A modern day rejuvenation of the regulatory competition debate can be found in Roberta Romano, “Empowering Investors: A Market Approach to Securities Regulation”, (1998) 107 Yale LJ 2359 and Roberta Romano, “The Need for International Competition in Securities Regulation” (2001) 2 Theoretical Inquiries in the Law 38 and Merritt B Fox, “The Securities Globalisation Disclosure Debate” (2000) 78 Washington University Law Quarterly 567. See more even-handed analyses in Howell E Jackson, “Centralisation, Competition and Privatisation in Financial Regulation” (2001) 2 Theoretical Inquiries in the Law 649; Coates, “Private vs Political Choice” (2001), *op cit* at n37.

<sup>43</sup> See William W Bratton and Joseph A McCahery, “The New Economics Of Jurisdictional Competition: Devolutionary Federalism In A Second-Best World” (1997) 86 Georgetown Law Journal 201 which points out the conditions and contexts suitable for regulatory competition.

<sup>44</sup> See chapter 7.

enforcement of the law. The following chapters will then apply a cybernetic model of regulation to examine how these *regulatory* aspects are framed and carried out within the current infrastructure, to determine the prospects of convergence.

This chapter will first discuss the substantive nature of securities regulation i.e. transactional securities regulation, regulation of intermediaries and regulation of markets. This sets the background for examining the new EU laws. On a preliminary note, the FSAP is not limited to securities regulation review and covers all financial services. Whether or not financial services should be regulated as different sectors, or functionally by objective, is still debatable. The FSAP did not go as far as to say that all financial services should be regulated under an integrated framework. The FSAP seems to apply a holistic approach to reforming the financial services regulatory framework in general, albeit retaining sectoral specific measures. It is positive that the FSAP takes a macro view of financial services as a whole and is cognisant of the possibilities that different financial services may be connected because of financial conglomerate activity and business, i.e. the provision of a variety of investment products or hybrid products by financial conglomerates.<sup>45</sup> The thesis limits its discussion to securities regulation reforms, as this sectoral specific approach is still taken in the Lamfalussy model, and there are sufficient unique characteristics in securities regulation. Although securities are investment products and it could be argued that all investment products could be regulated similarly, securities products are primary products upon which many secondary products such as futures or derivatives are based. Thus, securities products create direct relationships between corporations, investors, intermediaries and markets, whereas many derivative products do not. Securities transactions exchange ownership of a company for

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<sup>45</sup> The existence of financial supermarkets is the main driving force behind integration of regulation for financial services as a whole, see E.Ferran, "Examining the United Kingdom Experience in Adopting the Single Financial Regulator Model" (2003) 28 Brooklyn Journal of International Law 257. Dr Ferran also examines the advantages of the Financial Services Authority (FSA) being the single regulator, as well as the controversies. See also H Davies, "Reforming Financial Regulation: Progress and Priorities" in E Ferran and C Goodhart (eds), *Regulating Financial Services and Markets in the 21<sup>st</sup> Century* (Oxford: Hart 2001) at 17; C Goodhart, P Hartman, D Llewellyn, L Rojas-Suarez and S Weisbrod, *Financial Regulation: Why, How and Where Now?* (London: Routledge 2002) pp152-155.

capital, and this is not the case with other investment products, which provide contractual rights against the management/ providers of such products only. Although there is discussion that recommends treating all investment products as the same for the purposes of regulation, the separate treatment of securities regulation in the EU is not unwarranted.<sup>46</sup>

The discussion that follows examines how the substantive law of securities regulation in the EU has developed. The substantive law of securities regulation may be classified into 3 areas: first, the regulation of *securities products* found in transactional securities regulation, i.e. regulation dealing with offers of securities over primary markets and securities products on secondary markets, second, the regulation of *services*, which refers to the regulation of securities intermediaries' business and conduct; and third, the regulation of *markets* which refers to the regulation of the securities markets on which securities transactions are carried out. The regulation of products, intermediaries and markets are the three pillars of securities regulation.<sup>47</sup> The examination of the substantive reforms shows the extent and scope of regulatory convergence. Further, how the four aspects of regulatory convergence identified earlier relate to these substantive laws, will be explored in chapters 2 and 3.

## **4. Substantive Securities Regulation**

### ***4.1 Transactional Securities Regulation***

#### ***4.1.1 Rationales for Disclosure Regulation***

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<sup>46</sup> There are several models of financial regulation such as the functional/objective model, in e.g. France, Australia, where regulatory agencies are not devoted to specific sectors, but are formed according to the purpose for regulation, i.e. prudential regulation and business of conduct of regulation may be undertaken by different agencies. Whether the single regulator is necessary is debatable, see Jeremy W Markham, "Super-Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the US, UK and Japan" (2003) 28 Brooklyn J Of International Law 319. See also H.M. Schooner and M Taylor, "United Kingdom and United States Responses to the Challenges of Modern Financial Markets" (2002) 38 Texas International Law Journal 317.

<sup>47</sup> This classification is adopted in Niamh Moloney, *EC Securities Regulation* at n15.

Transactional securities regulation deals with the capital raising process, the offer of securities products in the primary market and the availability of such products in the secondary market. Securities products are available on 2 markets, first, the primary market, where corporate issuers directly offer their securities for the first time, or offer new issues, and second, the secondary market, where existing securities may be bought or sold by anyone. The pricing mechanism for primary offers may be subject to more distortions by the issuer or its underwriter, while the secondary market is able to provide for pricing more along the lines of supply and demand (subject to market-making activities). Thus, primary transactional securities regulation has been regulated more stringently and for longer, than secondary transactional securities regulation.

Primary transactional securities regulation is in the form of disclosure regulation, and where public offers are to be made for the first time, disclosure documents, i.e. prospectuses would need to be produced and would be subject to *ex ante* vetting by the regulators. Secondary transactional securities regulation is also underpinned by disclosure on a periodic or continuing basis, but these obligations are largely imposed and monitored by the securities markets themselves and thus are in nature, rather different from mandatory disclosure requirements applicable to primary transactions. This bifurcation is however now challenged as it is increasingly acknowledged that the rise in the volume of trading on secondary markets provides impetus for reforming the disclosure obligations over secondary markets.<sup>48</sup> The new securities Directives have adopted disclosure as the means of regulation in both primary and secondary markets, and have arguably streamlined the nature of disclosure required for both markets.

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<sup>48</sup> See paragraph 3, chp I of the Report of the Technical Committee IOSCO, *Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities* (Oct 2002).

Disclosure is described as a regulatory mechanism that facilitates independent consumer judgment and is not as intrusive as “command and control” types of regulation which prescribe specific standards that are more paternalistic in nature.<sup>49</sup> Disclosure regulation tends to be used in areas where there is shared responsibility between the ultimate users of a product or service, to discern for themselves what they would choose, and the state that should provide a framework of rules to facilitate adequate disclosure in order to allow users to make informed choices, and to deal with false descriptions.<sup>50</sup> Thus, disclosure regulation seems a balanced approach to securities regulation,<sup>51</sup> an apt price to pay for the benefits of capital raising.<sup>52</sup>

Mandatory disclosure for primary offers of securities has been justified because there is information asymmetry between investors and issuers. Issuers have to disclose all relevant information relating to the company and the worth of the securities they are issuing, information that otherwise would be very difficult to discover by investors. It could be argued that investors could pay analysts to find out what they need to know about the issuer. However, that makes investing very costly, and would not attract investors to the securities markets, thus adversely affecting issuers’ finance-raising process. Thus, it is in issuers’ interests to make disclosure voluntarily, and it could be argued that the amount of disclosure released to the market determined by such free market forces may be sufficient for investors.<sup>53</sup> However, it is doubtful that voluntary disclosure would ever be at its optimum, as

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<sup>49</sup> See Moloney (2003), op cit at n15, at 300, quoting from A Page and R Ferguson, *Investor Protection* (1992) pp59-77. A brief discussion of the various regulatory methods can be found in Martin Cave and Robert Baldwin, *Understanding Regulation* (Oxford: Oxford University Press 2003).

<sup>50</sup> William Cage, “Regulating Through Information: Disclosure Laws And American Health Care” (1999) 99 Columbia Law Review 1701.

<sup>51</sup> Len S Sealy, “The Disclosure Philosophy and Company Law Reform” (1981) 2 Company Lawyer 51 and Charlotte Villiers, “Disclosure Obligations in Company Law” (2001) 1 JCLS 181.

<sup>52</sup> See Mary G Condon, *Making Disclosure: Ideas and Interests in Ontario Securities Regulation* (Toronto: University of Toronto Press 1998) at 62-63, in which she discusses a number of reports issued for the purposes of recommending reform in securities regulation, that these reports all agree disclosure is an ideal regulatory mechanism due to its versatility and not too intrusive nature.

<sup>53</sup> The quantitative work done by George Stigler, “Public Regulation of the Securities Markets” (1964) 37 Journal of Business 117 and George J. Benston, “Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934” (1973) 63 American Economic Review 132 (Pt 1) have both doubted the

economic analysis provided by Professor Fox succinctly shows that, as long as the private cost of information disclosure<sup>54</sup> exceeds social cost, and social benefits exceed private benefits, voluntary disclosure would never be at the socially optimal point.<sup>55</sup> The strongest arguments for making disclosure mandatory are arguably that mandatory disclosure is necessary as some information would not be otherwise be disclosed if left to the initiatives of private corporations.<sup>56</sup> The market failure of certain disclosure makes a case for regulation to compel such disclosure. Disclosure of information may also be regarded as a “public good” that could only be provided by public regulation.<sup>57</sup> Mandatory disclosure also allows information to be disseminated in a standardised fashion<sup>58</sup> and levels the playing field for different investors with varying degrees of sophistication where access to information is concerned. These benefits of mandatory disclosure would only be provided if disclosure is made a regulatory subject and not left to self-regulatory efforts of the corporations or the market.<sup>59</sup>

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value of mandatory disclosure. Homer Kripke also agreed with Benston and Stigler in *The SEC and Corporate Disclosure: Regulation in Search of a Purpose* (New York: Law and Business Inc 1979). He argues that mandatory disclosure is not particularly useful as it is based on past performance, and the information is firm specific, allowing for no comparison with other industry players. Kripke also agrees with Jensen, Meckling and Ross, that management would be incentivised to make optimal levels of voluntary disclosure because the contracts between shareholders and executives would provide that, and management would be interested in having analysts profile the company as it results in higher share prices in the market. See Michael C Jensen and William H Meckling, “Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure” (1976) 3 *Journal of Finance and Economics* 305 and S Ross, “The Economics of Information and the Disclosure Regulation Debate” in F Edwards (ed), *Issues in Financial Regulation* (New York: McGraw-Hill 1979). However, Kripke’s work bundles the discussion against mandatory disclosure with the arguments against the SEC’s work, and critique against the SEC would be SEC-specific, and do not amount to attacks on the idea of mandatory disclosure *per se*.

<sup>54</sup> The private cost of voluntary disclosure is the fear of giving away a competition advantage the corporation may have. See Joel D. Seligman, “The Historical Need for a Mandatory Corporate Disclosure System” (1983) 9 *Journal of Corporation Law* 1

<sup>55</sup> Merritt B. Fox, “Rethinking Disclosure Liability in the Modern Era” (1997) 75 *Washington University Law Quarterly* 903.

<sup>56</sup> Frank H. Easterbrook, and Daniel R. Fischel, “Mandatory Disclosure and the Protection of Investors” (1984) 70 *Virginia Law Review* 669, also argued that private corporations have no incentive to make disclosure voluntarily that may allow other corporations to free-ride.

<sup>57</sup> It is argued that disclosure of information is a “public good” that has to be made obligatory by the state, John C Coffee, “Market Failure and the Economic Case for a Mandatory Disclosure System” (1984) 70 *Virginia Law Review* 717.. See also Joel D Seligman, “The Historical Need” (1983), *op cit* at n54 arguing that issuers would otherwise misrepresent or conceal information.

<sup>58</sup> See Easterbrook and Fischel, “Mandatory Disclosure” (1984), *op cit* at n56.

<sup>59</sup> The assumption being that regulators intend to achieve regulatory goals that they profess. See however, Condon, *Making Disclosure* (1998), *op cit* at n52 at chapter 1 that questions whether securities regulators behave according to professed goals.

Thus, the Public Offers Directive<sup>60</sup> affirmed disclosure regulation to be the most appropriate regulatory framework for primary securities transactions, and this has continued to be adopted in the Prospectus Directive enacted in 2004.<sup>61</sup>

The general objectives of mandatory disclosure would arguably need to be met on the secondary market as well, as much economic activity takes place on the secondary market. On secondary markets, mandatory disclosure is intended to achieve stock price accuracy, in order to maintain allocative efficiency and investor confidence. The Efficient Capital Markets Hypothesis posits that the full disclosure of information would enable investors to allocate their capital more efficiently in the secondary market.<sup>62</sup> This is because disclosure of information by corporations to the market would allow stock price to achieve an accurate reflection<sup>63</sup> of the value of the corporation at any one time, and thus, the information embedded in the price would help investors decide where to invest.

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<sup>60</sup> 89/298/EEC.

<sup>61</sup> More to be discussed in the next Part.

<sup>62</sup> It is arguably acknowledged amongst economists that the Efficient Capital Markets Hypothesis (ECMH) is not proved in reality. It may be partly due to the fact that investor behaviour is dependent on many other factors other than corporation disclosure. See Benston, "Required Disclosure and the Stock Market:" (1973), op cit at n53 (evidence suggests that mandatory periodic disclosure does not benefit investors); Irwin Friend and Randolph Westerfield, "Required Disclosure and the Stock Market: Comment", (1973) 65 American Economic Review 467 (Pt 1) (challenging Benston's analysis). However, economists also explain that capital market efficiency could be found in a strong form, a semi-strong form or a weak form ie that price adjustment to information disclosure may take place in various degrees and over different periods of time but that does not negate the policy objective towards achieving stock price accuracy. Eugene Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work", (1970) 25 Journal of Finance 383. See also Ronald J Gilson and Reiner H Kraakman, "Mechanisms of Market Efficiency" (1984) Virginia Law Review 549, where they further suggest that market efficiency is also dependent not only on the type of information disclosed, but also the distribution of information mechanisms and the costs of such mechanisms. Many economists still continue to uphold the ECMH. See discussion in Stephen F LeRoy, "Efficient Capital Markets and Martingales" (1989) 27 Journal of Economic Literature 1583 and Eugene F Fama, "Efficient Capital Markets II" (1991) 66 Journal of Finance (No. 5) 1575. The efficient markets theory assumes that investors are rational, and this assumption is being questioned in behavioural finance theory which posits that investor behaviour may be due to irrational concerns. See Lawrence A Cunningham, "Behavioural Finance and Investor Governance" (2002) 59 Washington & Lee Law Review 767, the random walk theory, in Robert J Schiller, *Irrational Exuberance* (New Jersey: Princeton University Press 2000).

<sup>63</sup> Marcel Kahan, Securities Law and the Social Costs of "Inaccurate" Stock Prices, (1992) 41 Duke Law Journal 977. See however Jeffrey N Gordon and Lewis A Kornhauser, "Efficient Markets, Costly Information and Securities Research" (1985) 60 NYU L Rev 761 where it is pointed out that it is uncertain whether the efficiency of any given market can be satisfactorily tested. However, Gilson and Kraakman have defended the thesis of information affecting price by looking at a variety of mechanisms affecting trading behaviour and concluding that the distribution of information into the market ultimately translates into stock price. However, see G Pepper, "The "Efficient Capital Markets Hypothesis: An Incomplete Theory"" in Stephen F Frowen and Francis P McHugh (eds), *Financial Decision-Making and Moral Responsibility* (London: St Martin's Press



Stock price accuracy in the market, on a macro level, also encourages investor confidence.

Where there is a legal mechanism such as mandatory disclosure, it assures the investing public that accuracy enhancement may be attained at a high level as disclosure is compelled as a matter of law. It has also been argued that where disclosure is made mandatory, it reduces the incidence of fraud, increases the reliability of estimates of firm value and reduces the volatility of securities price swings, thus giving the investor more confidence to invest in the markets.<sup>64</sup> Professor Seligman also presented quantitative evidence to show that the levels of fraudulent omissions decreased and quality of disclosure increased after mandatory disclosure came into effect after the Securities Acts of 1933 and 1934 in the US.<sup>65</sup> It has been recognized by the International Organisation of Securities Commissioners that very much more investment activity occurs in secondary markets than in primary markets and thus, a degree of protection is viewed as necessary for investors in the secondary market.<sup>66</sup> It has been documented elsewhere the rationales for treating disclosure in secondary markets on the same footing as disclosure over primary markets and the view that disclosure for primary offerings and ongoing disclosure should both be mandatory in nature could arguably be supported.<sup>67</sup>

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2000) at 106 (transactions may be carried out for liquidity purposes and are not information-related. Such transactions can be fed as information into the market and actually cause stock price inaccuracy).

<sup>64</sup> Joel D. Seligman, "The Reformulation of Federal Securities Laws Concerning Non-public Information" (1985) 73 Georgetown L.J. 1083 at 1118. However, the theory against fraud was criticised in Easterbrook and Fischel, "Mandatory Disclosure" (1984), op cit at n56.

<sup>65</sup> Joel D Seligman, *The SEC and the Future of Finance* (Praeger Special Studies 1983) at 205ff.

<sup>66</sup> See paragraph 3, chp I of the Report of the Technical Committee IOSCO, *Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities* (Oct 2002). Corporations benefit from the liquidity provided by secondary markets so that the equity provided would not be under threat of claw-back by the provider of the equity. This liquidity would be adversely affected if there should be a loss of investor confidence in the secondary market and thus, corporate disclosure, which is key to maintaining stock price accuracy in the secondary market, is necessary so that investors would stay in the secondary market. The secondary market also allows the shares of the corporation to be valued so that corporations may use their shares as valued security in debt finance or as currency in mergers and acquisitions. Corporations as well as investors both benefit from the maintenance of a liquid and informationally efficient secondary market.

<sup>67</sup> More arguments may be found in Iris H-Y Chiu, "Examining the Justifications for Mandatory Ongoing Disclosure in Securities Regulation" (2005) 26(3) Company Lawyer 67.

Mandatory disclosure meets many objectives in transactional securities regulation, but is not without cost. There is cost involved in preparing for disclosure, and such cost would be reflected in the offer price of the securities in an initial public offer.<sup>68</sup> Mandatory disclosure also removes the opportunity for privately negotiated transactions between issuer and investor which may be more efficient.<sup>69</sup> However, such cost may be perceived to be outweighed by the benefit of increased market liquidity.<sup>70</sup> Where the EU is concerned, disclosure regulation is utilised not only for its traditional objectives of investor protection and facilitation of efficient capital markets, but this regulation forms part of the positive integration in regulatory convergence.<sup>71</sup>

#### *4.1.2 Substantive Aspects of Disclosure Regulation*

The pre-reform position on disclosure regulation for primary offers of securities is found in a bifurcated framework distinguishing between listed and unlisted offers of securities. For all offers whether listed or unlisted, the Public Offers Directive lays down the minimum disclosure requirements. The disclosure requirements are couched in a general formulation i.e. what a reasonable investor would need to know. This general standard may be subject to different interpretations across Member States. There is no evidence that regulators have coordinated the interpretations of the Directive, and unlisted markets throughout the EU have maintained separate entry requirements anyway.

Issuers who intended to list their securities would have to comply with the Public Offers Directive in terms of preparing a prospectus, and they would also have to comply with the

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<sup>68</sup> Martin Sabine, *Corporate Finance- Flotations, Equity Issues and Acquisitions*, (London: Butterworths, 1993, 2<sup>nd</sup> ed ) gives an indication of the high costs involved in issuing securities.

<sup>69</sup> Alexander, "Establishing" (2002), op cit at n40 briefly discusses the rationales for securities regulation and the regulatory costs involved.

<sup>70</sup> Brian J Bushee and Christian Leuz, "Economic Consequences of SEC Disclosure Regulation" (2003) accessed at <http://fic.wharton.upenn.edu/fic/>, March 2005.

<sup>71</sup> Moloney, *EC Securities Regulation* (2003), op cit at n15.

much more detailed and harmonised requirements under the Admissions Directive<sup>72</sup> for admission to the listed market, and the Listing Particulars Directive, that standardised the items required to be disclosed to listed exchanges across the EU. The Admissions and Listing Particulars Directives<sup>73</sup> were much more specific in the disclosure and entry requirements to listed markets for issuers who intend to list. These Directives were premised on the assumption that multi-jurisdictional securities offerings were likely to be carried out by major or blue chip type companies in order to raise finance throughout European capital markets, and so, promulgating Directives dealing with listing would be sufficient to meet the market needs for pan-European access. As the amount of disclosure required of issuers who intended to list was at a higher threshold than if the issuers were going to be admitted to a second tier market (admitted to trading), this has resulted in a fragmentation of markets with smaller issuers opting to be traded on domestic second tier exchanges such as the Alternative Investment Market in London, but not actually moving out to other second tier markets in Europe which would impose different entry requirements.<sup>74</sup>

The reforms under the new securities Directives include an overhaul of the mandatory disclosure standards currently governed by the Public Offers Directive, and intend to remove the distinction between listed and unlisted markets so that the same disclosure and entry standards would apply to listed and second tier markets.<sup>75</sup> The new securities Directives still rely on disclosure as the foundational regulatory mechanism in primary and secondary markets. Under the Prospectus Directive, there is one set of disclosure obligations applicable to all issuers. These obligations have been set out in comprehensive detail in Commission

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<sup>72</sup> 79/279/EEC.

<sup>73</sup> 82/121/EEC.

<sup>74</sup> Detailed general discussion of the regime under the old securities Directives may be found in Moloney (2003), op cit at n15.

<sup>75</sup> Prospectus Directive, Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (Text with EEA relevance) OJ 2003 L345/64.

Regulations,<sup>76</sup> which are binding upon Member States without further transposition, in order to achieve maximum regulatory convergence throughout the EU. Maximum convergence in regulating disclosure also applies to regulation of collective investment units of securities and derivatives for investors.<sup>77</sup>

The standards of disclosure are also upgraded in accordance with the recommendations made by the International Organisation of Securities Commissioners (IOSCO) in 1998.<sup>78</sup>

Disclosure would also be more meaningful if supported by a common set of accounting standards that would be applied in evaluating financial disclosure by issuers. A common set of accounting standards would help achieve comparability of financial disclosure, to the convenience of investors. This has been achieved by the Accounting Standards Regulation which makes it mandatory for all issuers to prepare accounts in accordance with International Accounting Standards.<sup>79</sup>

Continuing disclosure obligations for issuers are introduced in the Transparency Directive,<sup>80</sup> Market Abuse Directive<sup>81</sup> and the Prospectus Directive.<sup>82</sup> The Prospectus Directive provides that an issuer must make yearly updates to the prospectus; the proposed Transparency Directive deals with periodic annual and half-yearly reporting of issuer financial and non-financial information, and the Market Abuse Directive requires issuer reporting of any *ad hoc*

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<sup>76</sup> Commission Regulation ECNo. 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses.

<sup>77</sup> Article 27(1), Consolidated Council Directive of 20 Dec 1985, on the coordination of laws, regulations and administrative provisions relating to undertakings in collective investment in transferable securities 85/611/EEC (UCITS Directive).

<sup>78</sup> *Report of the Technical Committee of the IOSCO, Securities Activity on the Internet* (Sept 1998), Part IV (A) and (B).

<sup>79</sup> Commission Regulation (EC) No 108/2006 of 11 January 2006 amending Regulation (EC) No 1725/2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standards OJ 2006 L24/1.

<sup>80</sup> Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC OJ 2004 L390/38.

<sup>81</sup> Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) OJ 2003 L96/16.

<sup>82</sup> *Op cit*, at n75.

price-sensitive information, in order to prevent market abuse such as insider dealing. In terms of collective investments, continuing disclosure has to be made by fund managers in yearly and half yearly reports.<sup>83</sup> The details of disclosure are prescribed in the UCITS Directive itself.<sup>84</sup> A general upgrade of continuous disclosure obligations to be “mandatory” and not merely administered by securities markets, is achieved in this round of securities reforms. However, the Transparency Directive does not envisage maximum regulatory convergence in its substantive laws. There is comparatively less detail prescribed as to how continuous disclosure should be made, and the Transparency Directive in particular expressly allows Member States to impose more stringent requirements such as quarterly reporting if they desire. This point will be returned to in the following chapters.<sup>85</sup>

Transactional securities regulation in the new EU framework is characterised by the continued use of disclosure as a regulatory mechanism, for the offers of securities products over the primary markets, and the availability of securities products over secondary markets. Primary disclosure standards have been upgraded and prescribed for regulatory convergence by Commission Regulations. Continuous disclosure standards have also been raised, with such disclosure being required at more intervals but more details are left to national regulators to decide.

## *4.2 Securities Intermediary Regulation*

### *4.2.1 Rationales for Regulation of Intermediaries*

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<sup>83</sup> Article 27, UCITS Directive.

<sup>84</sup> Annex I to the UCITS Directive.

<sup>85</sup> Article 3(1), Transparency Directive.

The rise of the financial intermediary was characterised by Professor Clark as representing an advanced stage of capitalism in the development of modern capitalist civilisation.<sup>86</sup> In this stage, capital suppliers relinquish their funds to intermediaries, and intermediaries would be competent to advise investors on investment choice. The intermediary's brokerage<sup>87</sup> services are essential to match suppliers and issuers of capital in the modern economy.

As securities intermediaries are in a position of relative trust and confidence *vis a vis* their capital supplying clients, what would be an appropriate form of regulation for such intermediaries? The old Investment Services Directive ("ISD") regulates intermediaries by pre-vetting, i.e. giving authorisation to operate upon satisfaction that intermediaries meet certain criteria, and by prescribing continuing rules of conduct for intermediaries.<sup>88</sup> This approach is continued in the Markets in Financial Instruments Directive<sup>89</sup> ("MIFID"), with an expansion into specific prescriptive rules for conduct of business, which were only generally dealt with in the old ISD.

The regulation of securities intermediaries is justified on the ground of investor protection. As intermediaries provide a range of services including investment advice for clients, they are in a principal-agent relationship *vis a vis* their clients, where the agent/intermediary bears a number of fiduciary responsibilities to the principal/investor. Where the agent has more knowledge or power than the principal, there is potential for agent shirking or abuse. Thus,

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<sup>86</sup> R.C. Clark, "The Four Stages of Capitalism: Reflections on Investment Management Treatises" (1981) 94 Harvard LR 56.

<sup>87</sup> Such as broking, dealing services, asset management services, and underwriting services, rather than auditing or analyst services. The utility of financial brokerage is briefly discussed in J Piesse, K Peasnell and C Ward, *British Financial Markets and Institutions* (London: Prentice Hall 1995) at 43 para 3.4.

<sup>88</sup> Some economists are of the view that banks need to be regulated as they borrow short and lend long and therefore have incomplete contracts and open-ended risk, but securities firms have complete contracts, may not suffer a run and need less regulation. See Franklin Allen and Douglas Gale, "Financial Intermediaries and Markets" Wharton School Financial Institutions Center Working Paper 00-44-C, 2003 (accessed 15 Nov 2005).

<sup>89</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC OJ 2004 L145/1.

legal intervention in prescribing agents' duties is often necessary to prevent abuse of the superior position in knowledge and trust.<sup>90</sup>

It may be argued that intermediaries could be relied on to self-regulate as they would protect their own reputations.<sup>91</sup> Reputational capital gives intermediaries their competitive edge vis a vis each other, thus the intermediaries' natural drive towards reputational protection acts as a form of control on abusive behaviour against clients.<sup>92</sup> However, research reveals that concern for reputation alone does not prevent wrong-doing.<sup>93</sup> As securities intermediaries are often large firms which carry out investment advice for investor clients, as well as underwriting and research work for issuer clients, there may be a conflict of interest in the intermediaries' provision of advice to investors, based on what may favour their issuer clients. The information asymmetry between the investor client and intermediary can be abused by intermediaries who may recommend securities investments based on what benefits their issuer clients.<sup>94</sup> However, as securities are generally described as "credence goods",<sup>95</sup> the

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<sup>90</sup> Johannes Köndgen, "Rules of Conduct: Further Harmonisation?" in Guido Ferranini (ed), *European Securities Markets: Investment Services Directive and Beyond* (London: Kluwer Law International 1993) at 118.

<sup>91</sup> See Stephen Choi, "Regulating Investors, Not Issuers- A Market-based Proposal" (2000) 88 California Law Rev 279 who challenges securities regulation in its traditional form. It is argued that regulation should be based on type of investor, in order to see how much issuer disclosure is needed.

<sup>92</sup> This line of argument can also be found in S Choi and J Fisch, "How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries" (2003) 113 Yale LJ 269. This piece however focuses more on auditors and analysts and how the economic structure may be created for them to engage in advisory research which would benefit securities investors.

<sup>93</sup> G. Richard Shell, "Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action" (1991) 44 Vanderbilt. Law Review 221, 266-70. The failure of reputational constraints is generally discussed in John C. Coffee Jr, "Understanding Enron: It's About Gatekeepers, Stupid" (2002) 57 Business Lawyer 1403.

<sup>94</sup> A.M. Pecces, "Financial Intermediation in the Securities Markets: Law and Economics of Conduct of Business Regulation" (2000) 20 International Review of Law and Economics 279. It may be argued that information asymmetry between intermediary and client may be corrected by the market presence of marginal investors who do research for themselves and will invest soundly. These marginal investors' trades would have a correctional effect on the price of the securities. Other market participants may benefit from this activity as they rely on the "corrected prices" A. Schwartz & L. Wilde, "Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis," (1979) 127 University of Pennsylvania Law Review 630.

<sup>95</sup> See D Llewellyn, *Economic Rationale for Regulation* (Financial Services Authority, Occasional Paper 1, April 1999), p34ff where it is argued that intermediary contracts are incomplete, with purchasers not knowing the real value for what it is worth at the time of contract, and in the long-term. See p36 where a detailed list of the characteristics of investments services is provided to distinguish them from other goods, thereby, warranting some form of regulation for investor protection. Peter D Spencer, *The Structure and Regulation of Financial Markets* (Oxford: Oxford University Press 2000) also accepts that financial services are generally credence goods, at 34, also Arthur R Pinto, "The Nature Of The Capital Markets Allows A Greater Role For The Government" (1989) 55 Brooklyn Law Review 77.

quality of credence goods is extremely difficult to ascertain. In order to protect investors relying on intermediaries in purchasing or selling such credence goods, some regulatory intervention may be warranted.

Thus, in line with IOSCO's resolution,<sup>96</sup> intermediary regulation is necessary for investor protection and ensuring that intermediaries provide an honest, fair and competent standard of service. Besides investor protection, such regulation could also achieve the wider benefit of avoiding the "lemons situation", which refers to a situation where investors are left to discern for themselves which investments or "lemons" are good, and which are bad, and when they cannot tell, they may become risk averse and withdraw capital.<sup>97</sup>

#### *4.2.2 Intermediary Regulation*

As mentioned, the first phase of securities regulation in the EU consisted of measures to harmonise the criteria for listed issuers to seek capital throughout the listed exchanges of Member States. Securities intermediary regulation in the EU lagged behind these initiatives and thus, the supporting framework for securities regulation was absent for some time. Although Member States had their own intermediary regulation, the standards of regulation were diverse. Only in 1993 was the Investment Services Directive passed to provide a passport for the provision of investment services across Europe, as well as to provide minimum harmonisation in regulating investment service providers.

The ISD sought to create an internal market for investment services, as well as to regulate intermediaries in terms of prudential aspects such as capital adequacy, and conduct of business, such as provision of investment advice and client order handling. The investment

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<sup>96</sup> IOSCO Resolution on International Conduct of Business Principles, Nov. 1990, Principles n. 1 and 2.

<sup>97</sup> Pecces (2000), op cit at n94.



services passport allowed a home Member State's authorisation to suffice for the offering of investment services in other Member States.<sup>98</sup> The availability of this passport resulted in the expansion of securities firms into cross-border provision of services, and the effects of the Directive could be regarded as generally successful.<sup>99</sup> The ISD is thus the first indication of a connection between regulatory harmonisation and integration of the EU market for investment services.

However, the success of the passport may be due to the fact that after the liberalisation of the internal market for issuers since 1977, securities intermediaries had intended to move across Europe and thus, demand from ground-up resulted in the ISD, which was just a response to a phenomenon already growing. Thus, increased cross-border activity may not be due to the magical effects of legal harmonisation and mutual recognition, but rather that such legal harmonisation and mutual recognition reflected existing market demand.<sup>100</sup>

The regulatory methodology for securities intermediaries is more prescriptive than the disclosure type regulation applicable to capital issuers. The features of this prescriptive regulatory framework consists of a pre-vetting authorisation process,<sup>101</sup> prudential regulation, in the form of requirements of financial soundness of the investment service provider, capital adequacy and soundness of management; and protective regulation in the form of rules of conduct of business and continuous supervision. A fall-back scheme in the form of the Investment Compensation Scheme has also been implemented.

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<sup>98</sup> Article 3(1) of the ISD. See however, the critique that the ISD's passport is not fully meaningful as it is limited to passporting "branches" and Member States could still enact laws to discriminate against foreign firms. Karen M. Smith, "The Need for Centralised Securities Regulation in the European Union" (2000) 24 Boston College of International and Comparative Law Review 205.

<sup>99</sup> Moloney, *EC Securities Regulation* (2003), op cit at n15 at 429.

<sup>100</sup> Gerard Hertig is of the view that pan-European businesses of corporate finance and asset management services pre-dated the passport initiatives of the Directives, see "Regulatory Competition for EU Financial Services" (2000) *Journal of International Economic Law* 349 quoting as source, I. Walter, *Global Competition in Financial Services* (Cambridge: Harvard University Press 1988).

<sup>101</sup> The perpetual problem that may plague an authorisation-type regulatory system is moral hazard ie those end-users rely on the state to certify worthiness and thus do not take responsibility for their decisions. See briefly Spencer, *The Structure and Regulation* (2000), op cit at n95 at 14.

Investment firms are pre-vetted in order to gain authorisation to provide services. Pre-vetting includes vetting of the fitness of directors and controllers of the investment firms. Prudential regulation is in the form of minimum capital adequacy.<sup>102</sup> Investment firms have to maintain capital adequacy at all times, and could suffer possible suspension of services if the capital adequacy should fall below the mandated requirement.

Protective regulation refers to conduct of business regulation that seeks to protect investors. Protective regulation deals with sound accounting and administrative mechanisms,<sup>103</sup> segregation of client assets from firm accounts,<sup>104</sup> prevention of conflicts of interests in investment firms' own trading and trading on behalf of clients,<sup>105</sup> ascertaining investor suitability for investments, adequate disclosure of risks, and addressing the fiduciary aspects of the relationship between investment intermediaries and investors.<sup>106</sup> Advertising and marketing which are more akin to "consumer-protection" aspects of investor protection, are however not covered.

The Investor Compensation Scheme represents the fall-back for investors should intermediaries default on investors.<sup>107</sup> Such a scheme may be claimed against when investment firms are unable to meet obligations and do not have the prospect of doing so.<sup>108</sup> Claims may also be made in respect of return of investors' funds or assets managed by the firms. The Scheme is then subrogated to the investors' rights against the firms concerned.<sup>109</sup>

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<sup>102</sup> Art 3(3), ISD requires firms to comply with the Capital Adequacy Directive, 93/6/EEC, OJ L141/1. See discussion by Moloney on the rationales and effectiveness of capital adequacy measures, Moloney, *EC Securities Regulation* (2003), op cit at n15 at 466ff.

<sup>103</sup> Art 9, ISD.

<sup>104</sup> [1993] OJ L170/32, corrigendum to the ISD.

<sup>105</sup> Art 10, ISD.

<sup>106</sup> Art 11, ISD, containing 7 general principles of conduct, worded in a rather generalist fashion.

<sup>107</sup> Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes OJ 1997 L84/22.

<sup>108</sup> Art 2(2) of the Investor Compensation Scheme Directive ("ICSD"), *ibid*.

<sup>109</sup> Art 12, ICSD.

In summary, the old ISD regime consisted of a passport methodology for creating an internal market, supported by a regulatory framework that addresses minimum standards such as prudential concerns, protective regulation and the provision of a fall-back Investor Compensation Scheme. The ISD was successful in terms of facilitating passport access and cross-border establishment. There was however, a provision in the ISD allowing intervention by host Member States if it were for the “general good”, allowing for divergent regulation in Member States where that could be justified.<sup>110</sup> Although such interventions could impede mobility to provide cross-border investment services, the European Court had allowed the protection of domestic investors to be a ground for “general good” to apply,<sup>111</sup> thus limiting the effects of the passport and minimum harmonisation. The protective regulation regime under the ISD was rather skeletal in nature, as only general principles were provided, leaving much discretion to the regulators in different jurisdictions to apply different interpretations. Moreover, it could be argued that minimum harmonisation<sup>112</sup> caused Member State divergences in regulation to persist, and prevented the complete integration of the market for investment services. Perhaps maximum harmonisation may resolve the persistent trend of divergences.<sup>113</sup>

Under the old ISD, there was also a split between home and host Member States in supervising and enforcing the prudential and protective regulation respectively. This had contributed to some fragmentation of the passport regime. The home state that approved the investment firms oversaw the prudential regulation, but the protective regulation was monitored and enforced by the host Member States. Thus, intermediaries who carried on

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<sup>110</sup> Art 19(6) ISD.

<sup>111</sup> See Case 205/84, *Commission v Germany*, [1987] 2 CMLR 8, with respect to insurance services, and Case 384/93, *Alpine Investments BV v Minister van Financien*, [1995] ECR I-1141.

<sup>112</sup> It was remarked in *Commission v Germany*, *ibid*, that where the Directive is silent, and national measures fill in the gaps for protecting their own investors, then such measures are justifiable under “general good”.

<sup>113</sup> However, one critic has argued that the ISD is in fact too prescriptive and does not draw the distinction between sophisticated and retail investors. The integration prospects of the market may have been adversely affected by such regulation! See Christopher Cruickshank, “Is there a Need to Harmonise Conduct of Business Rules?” in Ferranini, *European Securities Markets* (1993), op cit at n90 at 131.

business in many host states had to comply with multiple sets of conduct of business rules and the fragmentation of conduct of business rules increased compliance costs for intermediaries and also resulted in potential confusion. Critics also argued that the protective rules in some Member States were too severe and did not give enough heed to the sophistication of institutional investors.<sup>114</sup> However, the lesson learnt from the ISD seemed, at least to the Lamfalussy committee,<sup>115</sup> to be the provision of more EU level regulation in order to facilitate market integration. The MIFID therefore addresses protective regulation in greater detail, and provides some exemptions from protective regulation where “eligible counterparties”<sup>116</sup> are concerned, and also reforms the issue of supervisory responsibility.<sup>117</sup>

The new MIFID continues with the authorisation regime<sup>118</sup> and the passport approach,<sup>119</sup> to allow securities intermediaries to provide services throughout Member States based on home state approval. The MIFID also adopts prudential regulation under the Capital Adequacy Directive<sup>120</sup> earlier discussed. The MIFID embarks on extensive positive integration by providing for the fiduciary regulation of intermediaries. In place of the general principles of protective regulation under the old ISD, the MIFID and a supplemental Commission Directive provide detail in regulating conduct of business. The MIFID provides that intermediaries have to execute the orders on the best terms for their clients.<sup>121</sup> Intermediaries are also obliged to provide fair and sound information to their clients, including marketing

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<sup>114</sup> K.R. Ilmonen, “Changing the Investment Services Directive: Broker-Dealers and Sophisticated Investors” (2002) 23(5) Company Lawyer 135.

<sup>115</sup> The Lamfalussy committee felt that protective regulation under Article 11 of the ISD was too skeletal and caused national divergences to occur in regulation. See Lamfalussy report at 12, 23.

<sup>116</sup> Article 24, MIFID. “Eligible counterparties” mean counterparties of intermediaries who are also intermediaries, banks, financial institutions etc.

<sup>117</sup> Early critique on the bifurcation of supervisory responsibility came in the form of the European Commission’s Green Paper on Financial Services Meeting Consumers’ Expectations, COM (1996) 209, the Lamfalussy Report, and the European Commission’s 2000 Communication on Upgrading the Investment Services Directive, COM(2000) 729, at 7.

<sup>118</sup> Article 16, MIFID.

<sup>119</sup> Article 31, MIFID.

<sup>120</sup> Article 12, MIFID.

<sup>121</sup> Article 21, MIFID.

information.<sup>122</sup> Intermediaries are also obliged to seek information from their clients such as information on financial standing, investment appetite, knowledge and experience in order to “know-your-client” and provide suitable investment advice.<sup>123</sup> They are also obliged to identify conflicts of interests and make disclosure to clients,<sup>124</sup> and ensure that clients’ orders are handled in a prompt and fair manner.<sup>125</sup> These duties that intermediaries owe their clients are of a fiduciary nature, specifically provided for in legislation.<sup>126</sup> These rules however do not apply if intermediaries deal with “eligible counterparties” such as other intermediaries, banks and financial institutions.<sup>127</sup>

The MIFID also provides for home country control for intermediaries. The home state that gives authorisation would be in charge of supervising and enforcing against breaches. This is a shift from the division of responsibility between home and host states under the old ISD. But host states may be interested in some aspects of enforcement as their citizens may be prejudiced by breaches of conduct of business rules. The Directives have given host states limited powers. Host states may require periodic reporting<sup>128</sup> by intermediary firms so that they can monitor intermediaries, as long as these additional measures are not discriminatory in nature. They may not however directly enforce against an intermediary unless enforcement is justified as a “precautionary measure.”<sup>129</sup> In sum, the new intermediary regulation is subject to maximum harmonisation, which seeks to prevent national divergences by instituting home country control. This is consistent with the overall agenda towards regulatory convergence.

### 4.3 *Securities Market Regulation*

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<sup>122</sup> See Article 19(2) and (3), MIFID.

<sup>123</sup> Article 19(4), MIFID,

<sup>124</sup> Article 18, MIFID.

<sup>125</sup> Article 22, MIFID.

<sup>126</sup> Iris H-Y Chiu, “Securities Intermediaries in the Internet Age and the Traditional Principal-Agent Model of Regulation: Some Observations from EU Securities Regulation” (2007) *Virginia Business and Law Review* (forthcoming).

<sup>127</sup> Article 24, MIFID.

<sup>128</sup> Art 61, MIFID.

<sup>129</sup> Article 62, MIFID. The scope of these measures is much more limited than “general good”. Precautionary measures are discussed in Part 3.2 of chapter 3.

#### *4.3.1 Rationale for Regulating Markets*

The third aspect to be discussed in substantive securities regulation is the regulation of trading markets. It remains debatable as to whether there should be a regulatory framework for securities markets or whether the conduct of securities markets should be governed by market-driven forces. It has been argued<sup>130</sup> that the regulation of markets is necessary as complete contracting between the market and users of the market is too costly and regulation may provide a set of standardised terms for the market and end-users. However, it may alternatively be contended that market innovation may be stifled and end-users could bargain for better terms for themselves, especially since institutional membership is permitted on most exchanges. Sophisticated institutional members could significantly influence changes to be made.<sup>131</sup> The new securities Directives<sup>132</sup> have however taken a regulatory approach towards markets, expanding the turf of regulation from listed to unlisted markets, and from issues of admission and listing to market operations and reporting. The new market regulation seems to follow the general tenor of the other aspects of securities regulation, i.e. extensive coverage of regulation and convergence of standards.

The regulation of markets is found largely in the MIFID. A key issue the MIFID deals with is market transparency. Market transparency refers to the visibility of pre-trade and post-trade information.<sup>133</sup> Pre-trade information refers to information regarding offer prices and volumes on markets, and includes those offered by market-makers. The MIFID Commission

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<sup>130</sup> J Macey and M O'Hara, "Regulating Exchanges and Alternative Trading Systems-A Law and Economics Perspective" (1999) 28 *Journal Of Legal Studies* 17.

<sup>131</sup> For example, ground up feedback has made the London Stock Exchange adopt an online disclosure tool for reporting corporate governance in order to streamline the duplicate questionnaires and onerous reporting currently imposed on listed companies. See Sundeep Tucker, "Exchange to End Company Reporting Burden", *Financial Times* (15 August 2004).

<sup>132</sup> The Prospectus Directive, Market Abuse Directive, Markets in Financial Instruments Directive and Transparency Directive, mentioned above.

<sup>133</sup> For a discussion on the nature of transparency, see John Board, Charles Sutcliffe and Stephen Wells, *Transparency and Fragmentation* (London: Palgrave Macmillan 2002).

Regulation<sup>134</sup> specifies that pre-trade transparency for most systems would be the best 5 offers at different depths. However, pre-trade transparency may take a variety of forms, it could even be the whole limit order book as constantly updated. Market-makers are dealer-brokers who trade on their own account to provide liquidity quickly to the market. Post-trade information refers to information on concluded transactions, perhaps including price and volume of securities transacted, and may include time, venue and counterparties to transactions.

Markets will normally generate a certain level of pre-trade transparency as part of its business of attracting trade. Post-trade transparency also helps investors to evaluate the movement of stocks and trading patterns in order to make their own prospective investment decisions. Thus, even in the absence of regulation, markets are likely to generate some transparency. In the present landscape, an increase in electronic trading platforms and the multiplication of markets on a global scale mean that market fragmentation is becoming a reality,<sup>135</sup> and transparency across fragmented markets is increasingly difficult to achieve. Without regulation, some markets may remain opaque, serve dedicated users and may become fertile grounds for market abuse such as insider trading.<sup>136</sup> Moreover, market transparency also allows clients to compare trade execution information across markets. Such comparison could facilitate meaningful evaluation of an intermediary's performance, in assessing the quality of an intermediary's execution. Hence, market transparency could be justified in the interests of investor protection.

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<sup>134</sup> Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive OJ 2006 L241/1.

<sup>135</sup> Macey, and O'Hara, "Regulating Exchanges" (1999), op cit at n130.

<sup>136</sup> The relationship between fragmented markets and need for transparency regulation is discussed in Board, Sutcliffe and Wells, *Transparency and Fragmentation* op cit at n133 at 145ff.

However, critics have argued that disclosure of prices may be detrimental to the activities of market-makers.<sup>137</sup> This is because if market makers provide liquidity for a large trade, then their long positions may become exposed under pre-trade transparency and they could suffer losses if rivals drive down bids for the security concerned. Market makers provide a useful service of continuous liquidity and there seems to be some justification in keeping secret their positions. Although investors would consequently be deprived of some information for their investment decisions, it may be argued that there is nothing really unfair in some investors getting a better deal as broker-dealers may favour long term customers and customers who wish to move large volumes. It is accepted in retail transactions that larger volumes of purchases may merit discounts or familiar customers may have privileges, so why not in securities transactions?<sup>138</sup> Some commentators have advocated that there is a trade-off between liquidity in the market and total market transparency, and the level of trade-off could be determined by market forces which would balance market-makers' interests against investor demands.<sup>139</sup>

However, recent surveys indicate that regulating price transparency does not have an adverse effect on market-making, especially since a limited deferral of reporting is allowed in many exchanges, and that such regulation also does not adversely affect liquidity or attractiveness of the regulated market concerned.<sup>140</sup>

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<sup>137</sup> R Lyons, "Optimal Transparency in a Dealership Market With an Application to Foreign Exchange" (1996) 5 *Journal of Financial Intermediation* 225. It has also been commented that US and London exchanges are quote-driven, as are the exchanges in most Nordic countries and Germany, while France and the "Club Med" group of countries are transaction-driven. Quote-driven markets depend on market-making to provide fast liquidity, and these markets may be more adversely affected by transparency regulation. See Kerry J. Houghton, "The Economic and Political Debate Over the Regulation of Off-Exchange Securities Trading in the EC's Single Financial Market" (1992) 32 *Virginia Journal of International Law* 747.

<sup>138</sup> See Brian Scott-Quinn, "Ethics and Regulation in Securities Market Making" in Stephen F Frowen, and Francis P McHugh, (eds), *Financial Decision-Making and Moral Responsibility* (2000), op cit at n63 at 96.

<sup>139</sup> Jonathan R Macey, "Regulation in the US Federal System: Banking and Financial Services" in Daniel C Esty and Damien Geradin (eds), *Regulatory Competition* (2003), op cit at n36 at 95ff.

<sup>140</sup> Board, Sutcliffe and Wells, *Transparency* at 214-38.



Another controversial issue that has dogged regulatory reform for markets is the issue of market concentration. This relates to whether there should be centralisation of trades on particular large markets. It may be argued that market activity should be centralised or else the fragmentation of markets would result in worse bid/sell spreads in disparate markets as supply and demand are diffused. However, allowing multi-market trading may enhance liquidity for investors and may also create healthy competition that may result in market innovation for better rules and practices, as well as technological innovations that would benefit investors.<sup>141</sup> Centralisation of trades may also be a way to allow protectionism in by the back door.<sup>142</sup> The MIFID has settled for a no-centralisation policy.

The other aspect in regulating markets relates to enforcement against market abuse. If left to market forces, market abuse such as insider trading and market manipulation may take place and not be penalised, unless markets themselves are so adversely affected by bad reputation that they would regulate themselves against bad practices. The reputational incentive for self-discipline is very important as many exchanges in Europe have been self-regulating for a long time.<sup>143</sup> However, technological advancements have allowed for the proliferation of many small alternative markets. These small alternative markets may not be affected so much by reputational cost as they are not national icons like the larger, usually national, exchanges; and could operate in a “fly-by-night” manner.<sup>144</sup> Furthermore, smaller systems may not have

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<sup>141</sup> It has also been argued that multi-market trading may hurt liquidity as the cost of fragmentation of markets outweighs the potential benefits of liquidity increases. See Y Amihud and Haim Mendelson, “A New Approach to Regulation of Trading Across Securities Markets” (1996) 71 NYU Law Rev 1411 where it is argued that the issuer should consent to the trading of their securities on the secondary market as the issuer has the interest of maximising the value of the securities. This would provide a market-driven force for regulating the orderly trading of the issuers’ securities. See also M Klock, “The SEC’s new Regulation ATS: Placing the Myth of Market Fragmentation Ahead of Economic Theory and Evidence” (1999) 51 Florida Law Rev 753 where it is argued that parallel markets have not demonstrated any harm to investors, and have provided liquidity and innovation benefits..

<sup>142</sup> Brian Scott-Quinn in Frowen and McHugh, *Financial Decision-Making* (2000), op cit at n63 at 97.

<sup>143</sup> For example, the London Stock Exchange was a regulator in respect of pre-vetting prospectuses for listing and ensuring that listing requirements were met. See also Mahoney’s opinion that the exchange could be capable of regulatory functions. Paul G Mahoney, “The Exchange as Regulator” (1997) 62 University of Chicago Law Review 1047.

<sup>144</sup> See collection of papers in David Frase and Helen Parry (eds), *Exchanges and Alternative Trading Systems* (London: Sweet & Maxwell 2000). See also Daniel M Gallagher, “Move Over Tickertape, Here comes the

adequate resources to police and enforce against market abuse. Thus, regulating market abuse has increasingly become important in securities regulation.

The rationales for market regulation are multi-faceted and some aspects may not be as clearly warranted. However, the failure of, or disorderly trading in,<sup>145</sup> markets may be a source of systemic risk if markets should fail, and the presence of systemic risk may warrant some form of regulatory supervision over market construction and activity.<sup>146</sup>

#### *4.3.2 Regulation of Securities Markets*

The EU's approach in regulating markets has hitherto been a light touch. Under the old ISD, market regulation was minimal. The ISD adopted the concept of a "regulated market" to allow Member States to designate which markets would be regulated under the ISD. Thus, Member States could opt to submit only the few larger markets and leave domestic pools of liquidity entirely out of EU regulation. This also represented a compromise between the "North Sea" group of countries consisting of the UK, Germany, and the Nordic jurisdictions which favoured lighter regulatory touches in market regulation, and the "Club Med" group of countries consisting of France, Italy and Southern parts of Europe, which favoured heavier market regulation and market concentration.<sup>147</sup> Therefore, the ISD provided that Member States may designate certain trades that could only be carried out on the designated regulated

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Cyber-Exchange: The Rise of Internet Based Securities Trading Systems" (1998) 47 Catholic University Law Review 1009 which explains the changing landscape and the SEC's response to this in the US.

<sup>145</sup> This has been argued to be difficult to define, as orderliness may not have anything to do with efficiency, and "disorderly" markets may still remain efficient and competitive. This calls for an examination of what regulation of markets really seeks to achieve. See Caroline Bradley, "Disorderly Conduct: Day Traders And The Ideology Of "Fair And Orderly Markets"(2000) 21 Northwestern Journal of International Law and Business 657.

<sup>146</sup> See Karel Lannoo, "Challenges to the Structure of Financial Supervision in the EU" (2000) 2(4) JIFM 98, where it is argued that certain harmonisation of rules at the EU level need not take place as they do not affect systemic risk.

<sup>147</sup> E Wymeersch, 'Control of Securities Markets in the European Economic Community', 'Commission of the European Communities, Collection Studies, Competition Approximation of Legislation Series No 31 (1978), quoted in L Gharzaniti, "Single Market-Making- EC Regulation of Securities Markets" (1993) Company Lawyer 43.

markets, for the benefit of Member States that favoured market concentration.<sup>148</sup> This compromise has been criticised as markets are unevenly regulated.<sup>149</sup> The new MIFID now allows market dispersion to take place, and seeks to regulate them all under a set of common standards of transparency, reporting and access.

The MIFID now provides for markets to be approved and continuously supervised by home country authorities.<sup>150</sup> The approval of markets depend on criteria such as the soundness of its management,<sup>151</sup> the availability of sound operating facilities<sup>152</sup> and structures, and fair and open rules on admission and removal from trading.<sup>153</sup> Markets are also required to allow access to intermediaries without undue restrictions, so as to complement the intermediary passport.<sup>154</sup> Market regulation in the ISD was patchy and skeletal and not quite as comprehensive as intermediary regulation. The rise of alternative trading systems not captured in market regulation also posed as a regulatory challenge.<sup>155</sup> The ISD treated alternative trading systems in the same manner as investment firms, but such an approach was not necessarily ideal.<sup>156</sup>

The MIFID now makes special provision for the alternative trading system, known as “Multilateral Trading Facility” (“MTF”). Much of the regulation of MTFs is not dissimilar to regulation of investment firms, but the MIFID provides some special conduct of business

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<sup>148</sup> Art 14(3) ISD.

<sup>149</sup> Fabrice Demarigny, “A European Directive for Regulated Markets? A French Reaction” in Ferranini (ed), *European Securities Markets* (1993), op cit at n90.

<sup>150</sup> Article 36, MIFID.

<sup>151</sup> Articles 37-8, MIFID.

<sup>152</sup> Article 39, MIFID.

<sup>153</sup> Articles 40-1, MIFID.

<sup>154</sup> Article 42, MIFID.

<sup>155</sup> See R Karmel, “Regulatory Initiatives and the Internet: A New Era of Oversight for the SEC” from a Symposium on Regulation of Securities and Security Exchanges in the Age of the Internet, (2001-2) NYU Journal of Legislation and Public Policy 33 where it is argued that the Internet allows dissemination of information and SEC’s regulatory mechanism would not be able to cope with the Internet’s boundless methods of information dissemination.

<sup>156</sup> Although the US promulgated Regulation ATS, the Regulation does not give particular in- depth consideration to the nature of the ATS. Regulation ATS allows firms to opt as to whether they would be regulated like investment firms or like markets (which would mean self-regulation) See critique by M Klock, “Regulation ATS” (1999), op cit at n141.

rules for the MTF, such as pre and post-trade transparency disclosure.<sup>157</sup> It should be noted that the operation of an MTF does not require separate approval, unlike for the operation of markets. The MIFID still draws a line of difference between the MTF marketplace and a traditional exchange. Title III of the MIFID contains special provisions pertaining to “regulated markets”, which likely refer to exchanges. The regulator’s extra powers in relation to exchanges include approval of the controlling interests<sup>158</sup> and management of exchanges,<sup>159</sup> and the power to suspend and remove financial instruments from trading.<sup>160</sup> Although MTFs and traditional exchanges are both marketplaces, the MIFID regulates the latter more stringently. However, it may be argued that regulators also have oversight of the persons who effectively control an investment firm and the owners of investment firms,<sup>161</sup> and since many MTFs are run by investment firms, similar regulator oversight exists for both regulated markets and MTFs. However, there is lack of express mention of a regulator’s power to suspend or remove instruments from trading on an MTF. It may be envisaged that in times of emergency where such suspension or removal may be warranted on a regulated market, any continued trading on MTFs may result in market and systemic risks.<sup>162</sup> There is room to query if a bifurcated approach is warranted in distinguishing between regulated markets and MTF marketplaces.<sup>163</sup> Other obligations imposed on an MTF such as reporting requirements, are the same as for investment firms.<sup>164</sup>

In terms of the hard fought issue of market transparency, the original compromise position reached in the ISD between Member States favouring quote-driven markets and Member

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<sup>157</sup> Articles 28-9, MIFID.

<sup>158</sup> Article 38.

<sup>159</sup> Article 37.

<sup>160</sup> Article 41.

<sup>161</sup> Articles 9 and 10, and Article 9 of the Commission Directive that places the responsibility for firm compliance on senior management.

<sup>162</sup> Randolph James Amaro Jr, “European Union Regulation of Electronic Communication Networks: Stifling Global Integration of Securities Markets” (2002) 20 Wisconsin International Law Journal 397.

<sup>163</sup> Richard Britton, “The Differences between Exchanges and Alternative Trading Systems” (2000) 2(5) JIFM 170.

<sup>164</sup> Article 26, MIFID.

States favouring transaction-driven markets was that:<sup>165</sup> averaged transacted prices over the last 2 hours were to be published as well as averaged transacted prices the following morning when markets opened. The MIFID has again upgraded the standards of transparency required, to require post-trade transparency to be made available within 3 minutes of the close of the transaction.<sup>166</sup> The MIFID also requires investment firms that carry out systematic internalisation for securities that have liquid markets to provide pre- and post-trade transparency, so that “in-house” cancelling of orders would not be totally opaque to the market. The MIFID has therefore come down on the side of promoting a minimum standard of transparency across all venues where transactions may occur.

A point of interest is that, like under the ISD, the MIFID does not provide any form of common remedial mechanisms against markets.<sup>167</sup> This means that the MIFID does not provide for how markets should compensate users if they themselves should be liable for regulatory breaches. However, this may not have been a concern as it was not envisaged that regulated markets would provide services to investors directly.

Market regulation has also omitted the issue of regulating the relationship between clearing and settlement systems and markets. This has been criticised as the integrity and reliability of a common clearing and settlement procedure would be crucial to investor protection and enhancing the reputation of European markets.<sup>168</sup> However, this issue may arguably be dealt with at the level of European competition law.<sup>169</sup>

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<sup>165</sup> Ferranini however argues that transparency levels are best set by market-driven forces and should not be regulated. See G Ferranini, “The European Regulation of Stock Exchanges: New Perspectives” (1999) 36 CMLR 569.

<sup>166</sup> MIFID Commission Regulation 2006.

<sup>167</sup> This point is raised by Manning Glibert Warren III in “The European Union’s Investment Services Directive” (1994) 15 University of Pennsylvania Journal of International Business Law 181.

<sup>168</sup> Andrew Whittaker, “A European Law for Regulated Markets? Some Personal Views” and Hal S Scott, “Regulation of the Relationship between European Union Stock Exchanges: Lessons from the US” in Ferranini (ed), *European Securities Markets* (1993), op cit at n90 at 269 and 283 respectively.

<sup>169</sup> See the saga of takeover rejections by the London Stock Exchange with regard to offers by the Deutsche Börse and the Euronext, over verticalisation with clearing and settlement systems, which was viewed as anti-

### 4.3.3 Regulation of Market Abuse

The other aspect of market regulation is in relation to market abuse, i.e. insider trading or manipulation of share prices. Although some commentators believe that market abuse could be left to self-regulation by exchanges, this is highly controversial and may not be in the interests of investor confidence.<sup>170</sup> The main rationale for regulating insider trading is the potential adverse impact such behaviour may have upon investor confidence, affecting market robustness and corporate finance in the long run.<sup>171</sup>

The old Directive dealing with insider trading was the Insider Dealing Directive (hereinafter known as the “IDD”).<sup>172</sup> This Directive dealt with the definition of inside information, who was an insider, and what constituted insider dealing, and mandated that every Member State provide criminal sanctions against insider dealing. Some Member States such as Germany did not, before the adoption of this Directive, have criminal sanctions against insider dealing. However, it is generally acknowledged that the IDD is not a sufficient measure to regulate

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competitive, Norma Cohen, “LSE set to Reject Merger Moves”, *Financial Times* (24 Oct 2004). The LSE has also rejected offers from Macquarie Bank and NasDaq from 2005-6.

<sup>170</sup> Amir Licht discusses the context of globalisation of stock exchanges and the ability of issuers to move to various exchanges around the world. He is of the view that securities regulation would still remain integral even without an international securities regulator. See “Stock Exchange Mobility: Unilateral Recognition and the Privatisation of Securities Regulation” (2001) 41 *Virginia Journal of International Law* 583. However, N Poser argues that in the age of globalisation, exchanges would become more self-regulatory in the absence of an international securities regulator, “The Stock Exchanges of the United States and Europe: Automation, Globalisation and Consolidation” (2001) 22 *University of Pennsylvania Journal of International Economic Law* 497.

<sup>171</sup> Roberta S. Karmel, “Outsider Trading on Confidential Information: A Breach in Search for a Duty” (1998) 20 *Cardozo Law Review* 83 at 103 (The SEC's insider trading policy is best understood as an effort to achieve fair pricing in the public securities markets). See Seligman, “The Reformulation” (1985) *op cit* at n64 at 1115 (arguing that investors must be confident that they can trade securities without being victims of informational disadvantages); see also Donald C. Langevoort, “Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation”, (1999) 99 *Columbia Law Review* 1319 at 1325-28 (contending that the connection between insider trading regulation and maintaining investor confidence is at best speculative). There are also other theories explaining the regulatory rationale for insider trading, such as the “misappropriation” theory which is based on misappropriation of a company's proprietary information. The most controversial support for not regulating insider trading came from H Manne in 1966, in *Insider Trading and the Stock Market* (New York: Free Press 1966) where it is argued that insider trading helps to feed price information into markets and thus accelerates the settling of the market price at an efficient level.

<sup>172</sup> Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing OJ 1989 L334/30.

market abuse in general, as market manipulation is not caught by the IDD, and could be practiced in myriad forms. The Lamfalussy report picked up on this weakness and recommended a more comprehensive regulation of market abuse in general.<sup>173</sup> A harmonised regime in the Market Abuse Directive now provides definitions for market abuse, including insider dealing and market manipulation, and the compelling of timely disclosure of information in order to prevent market abuse.<sup>174</sup> The Directive also recommends administrative sanctions for market abuse<sup>175</sup> and the enhancement of supervisory coordination between Member States to detect and enforce against market abuse.<sup>176</sup> The MIFID further imposes obligations on investment firms, MTFs and markets to report on suspicious transactions and monitor orderly trading in markets.<sup>177</sup>

On the whole, market regulation has started with patchy regulation of some aspects of market trading, and insider dealing. The reforms that have been put into place in the MIFID and Market Abuse Directive are intended to create a more comprehensive system of market regulation. A point of critique that may be raised here is that, the MIFID is still very much based on the assumption that markets are national, and that there would be one home country regulator for its approved regulated markets. This approach seems to be lagging behind real market developments as pan-European alliances such as Euronext<sup>178</sup> have already been in place for some time.

## **5. Conclusion**

This chapter has given a historical review of how EU securities regulation has developed, and how the FSAP and Lamfalussy Report have culminated in the introduction of a new era of

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<sup>173</sup> Lamfalussy Report, at 12.

<sup>174</sup> Art 6, Market Abuse Directive.

<sup>175</sup> Art 14, Market Abuse Directive.

<sup>176</sup> Art 16ff, Market Abuse Directive.

<sup>177</sup> Articles 26 and 43, MIFID.

<sup>178</sup> The merger of the Paris, Amsterdam and Brussels exchanges.

regulatory convergence. The substantive laws of the new Directives seem geared towards regulatory convergence, as the Directives generally provide for comprehensive coverage of regulatory standards, as distinct from the old approach of minimum harmonisation (except the Transparency Directive). The Directives also provide for passports for most aspects of securities products and services, and institute a supervisory structure of home country control to minimise fragmentation in supervision.

Regulatory convergence is however not only premised upon the maximum harmonisation of substantive laws. Chapters 2 and 3 will examine the notion of regulatory convergence in law in “books” as well as law in “action”.<sup>179</sup> Chapter 2 argues that there are 4 aspects to regulatory convergence, and these are the sources of law, administration and interpretation of law, supervision over compliance with the law and the enforcement of law. Chapter 2 proposes that a cybernetic model of analysis should be applied to determine the prospect of convergence in all four aspects of regulatory convergence. Cybernetics is an analytical method or philosophy that permeates many disciplines in studying systems, whether as physical, biological or social systems, and encompasses both an objective perspective i.e. what a system ought to do or be, as well as a subjective perspective i.e. what a system is or does, according to the players within the system.<sup>180</sup> It treats the system as capable of existing in an autopoietic<sup>181</sup> manner, and provides an internal form of analysis, without discounting the possibility of external influences. It seems appropriate to evaluate regulatory convergence in this way, as regulatory convergence in EU securities regulation seems to be a rather autonomous movement in the diverse backdrop of EU governance, suggesting its potential to be assessed as a self-referential and autopoietic system. This thesis proposes to utilise the general cybernetic benchmark which could be applied to evaluating any system, to evaluate

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<sup>179</sup> Murray J. Horn, *The Political Economy of Public Administration* (Cambridge: Cambridge University Press 1995) at ch 1.

<sup>180</sup> W Ross Ashby, *An Introduction to Cybernetics* (London: Chapman and Hall 1957).

<sup>181</sup> Discussed in greater detail in chapter 2.



regulatory convergence from the systemic perspective. The cybernetic model will be used to assess the prospects of regulatory convergence, and provide some observations on what the strengths and weaknesses are, of the methodologies employed to foster convergence in each area of regulatory convergence.

Chapter 4 will then take the discussion to a more macro level and query if there is an EU regulatory system in securities regulation for the purposes of regulatory convergence. In particular, chapter 4 will inquire if the Lamfalussy process or CESR's governance may amount to a system for EU securities regulation.

Chapter 5 then discusses the forces for divergence amongst Member States, and will discuss issues such as regulatory competition, network effects and theories on multi-speed clustering among Member States that may be more like-minded. Chapter 6 then concludes that there are insufficient systemic features in the current framework to achieve regulatory convergence in the cybernetic sense. The agencification of CESR is arguably necessary to achieve regulatory convergence in the cybernetic sense. The implications of the conclusion to chapter 6 will be examined in Chapter 7. Chapter 7 is also a concluding chapter that sums up the developments of thought in the foregoing chapters and future directions for research emanating from the conclusions of this thesis.

## Chapter 2

### Conceptualising Regulatory Convergence in EU Securities Regulation

#### 1. The Meaning of Regulatory Convergence

“Regulatory convergence” consists of two aspects, i.e. “regulation” and “convergence”.

Regulation seeks to provide a sustained and focused approach to modify the behaviour of the subjects of regulation, so that compliance may be secured according to the standards and goals in such regulation.<sup>1</sup> The *regulatory approach* in EU securities regulation is the imposition of EU level laws. However, as written law is open-textured in nature, i.e. the language used to express the written law cannot be completely close-ended, importing of no discretionary application,<sup>2</sup> regulation is a process that not only consists of the written law itself, but the interpretation, administration and enforcement of the law. Thus, in looking at regulatory convergence, convergence is looked at in all aspects of *regulation*, from the law in books to the law in action. This thesis suggests that EU securities regulation consists of four key aspects, i.e. 1) the written law itself, that is the substantive source of law, 2) the interpretation and administration of the law (including national transposition where relevant), 3) the supervision of compliance with the law, and 4) the enforcement of the law. The convergence of EU securities regulation will therefore be examined in these 4 respects, i.e. the convergence of sources, interpretation and administration, supervision and enforcement.

This chapter will discuss the convergence of sources of EU securities laws, while chapter 3 will deal with interpretive, supervisory and enforcement convergence.

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<sup>1</sup> The meaning of “regulation” may be found in P Selznick: “Focusing Organizational Research on Regulation”, in R.G. Noll (ed.), *Regulatory Policy and the Social Sciences* (Berkeley, University of California Press, 1985) at 363-7. See also G. Majone (ed.), *Deregulation or Re-regulation? Regulatory Reform in Europe and the United States* (New York, Pinter, 1990) at 1-6; A Ogus, *On Regulation: Legal Form and Economic Theory* (Oxford: Clarendon 1994); Karen Yeung, *Securing Compliance* (Oxford: Hart 2004) at 5 and 11.

<sup>2</sup> H.L.A. Hart, *The Concept of Law* (Oxford: Clarendon 1961) at 124ff.

There are two processes in regulatory convergence. Regulatory convergence may be secured through a combination of “top-down” and “bottom-up” approaches.<sup>3</sup> The “top-down” aspect of convergence is the focus of this thesis, as this thesis examines the extent to which direction is supplied for convergence in the sources of law, interpretation and administration, supervision and enforcement, and the cybernetic model of analysis is used to evaluate these aspects. The “bottom-up” aspect refers to incentives and behaviour of Member States to converge, i.e. national efforts voluntarily synchronising with EU level direction. Chapter 5 of the thesis deals with the bottom-up aspect, discussing the various forces and factors that may lead Member States to regulatory divergences, and illustrates the potential gap between national interests and EU legislation in securities regulation, in order to emphasise the difficulties that may be faced in the top-down securing of regulatory convergence.

In this chapter and the next, regulatory convergence will be examined using a cybernetic model of analysis. Cybernetics is the study of how systems work, whether the systems are biological, mechanical or regulatory.<sup>4</sup> This thesis suggests that regulatory convergence in EU securities regulation is both a process, as well as a goal. The study of cybernetic systems provides insights as to how processes can be directed to achieve goals. It may be argued that the cybernetic model is too high a benchmark as EU regulation consists of a pan-European level and national implementing levels, and is a form of mixed governance<sup>5</sup> that may not be susceptible to the level of centralised direction and control inherent in a cybernetic system. However, cybernetics allows the study of parts of systems to understand how the whole system works together, and this theory is thus potentially applicable to study a system such as “regulatory convergence” in EU securities regulation, which presupposes a certain direction

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<sup>3</sup> This terminology is taken from Europeanisation studies, a branch of political science. See Claudio Radaelli, “The Role Of Conceptual Analysis In Europeanisation Research”, paper presented at the conference “Europeanisation: Theories and Research”, University of Copenhagen, 16 Feb 2006.

<sup>4</sup> The pioneering work in cybernetics is found in Norbert Wiener, *Cybernetics or Control and Communication in the Animal and the Machine* (Hermann Editions in Paris; Cambridge: MIT Press, Wiley & Sons in NY 1948). See also generally, W. Ross Ashby, *An Introduction to Cybernetics* (London: Chapman and Hall 1957).

<sup>5</sup> Discussed in greater detail in Part 2.4.5.

and aim. Moreover, it could be argued that “regulatory convergence” in EU securities regulation could potentially amount to a distinct system of regulation (or “regulatory sector”), which takes on a more centralised form of governance. The idea of a “regulatory sector” is derived from an eminent commentator’s discussion on the integration of the EU through law.<sup>6</sup> Although that discussion focuses on enforcement fragmentation among Member States, and queries whether the European Court may provide any harmonisation, the discussion suggests that the European Court has taken,<sup>7</sup> and may take a “sectoral” approach in providing judicial harmonisation for remedial and procedural measures that would harmonise enforcement in certain issue areas, such as state aids. The “sectoral” approach regards different policy issue areas as almost distinct, so that the regulatory imperatives pursued for each may be regarded as largely separate from other areas. The “sectoral” approach to conceptualising regulatory governance in the EU is also supported by Armstrong and Bulmer who define the governance of the Internal Market by reference to “policy areas” or “governance regimes”.<sup>8</sup> It may also be suggested that the division of the Commission along policy issue areas to be administered under the auspices of different Directorates, shows how the Commission conceptualises regulatory governance in the EU- that different policy areas are treated differently and hence the regulatory governance of each policy area may be different. In this way, a centralised form of governance in EU securities regulation may arguably exist alongside other regulatory sectors in the mixed governance landscape at the EU level.

Cybernetics is also supportive of the idea of autopoiesis in law. This is important as regulatory convergence *could* potentially exist in a distinct and autonomous manner, in the sector of securities regulation, apart from the more fluid forms of governance discussed in Part 2.4.5. Using a cybernetic benchmark, this thesis can explore the extent to which such

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<sup>6</sup> Michael Dougan, “Enforcing the Single Market: Judicial Harmonisation of National Remedial and Procedural Rules” in C Barnard and J Scott eds, *The Law of the Single Market* (Oxford: Hart 2002) at 153.

<sup>7</sup> Case C-24/95, *Alcan II* [1997] ECR I-1591.

<sup>8</sup> Kenneth Armstrong and Simon Bulmer, *The Governance of the Single European Market* (Manchester: Manchester University Press 1998) at 56.

autonomy may be achieved by law to frame a distinct system of regulatory convergence. Autopoiesis<sup>9</sup> is a general theory that posits that all systems such as sociology, law and political science and so on, are autonomous systems which are hermetically closed but cognitively open to observe other systems. These systems have normative paradigms of their own that determine rule-setting within the systems. The system is self-referential and self-contained in its legitimacy and competency. The rules would not be changed by changes in other systems. Teubner's version of autopoiesis posits that systems do take into account of the wider context of changes, so autopoietic systems are dynamic in nature, and can respond to the changing landscape of EU governance. The essence of an autopoietic system is that changes within the system is selected and acted upon by the system itself and not directly *controlled* (although may be influenced) by external changes. This is relevant to the study of regulatory convergence as a system. This thesis examines how EU securities law as an autopoietic system of law, engages in the converging process and the focus is placed on the characteristics of the law itself, to ascertain how those characteristics frame the convergence process. Thus, autopoietic assumptions allow this thesis to place less emphasis on external driving forces such as political power, although such driving forces are by no means lacking in influence.

It may be criticised that autopoiesis does not reflect the complexities of EU governance, as dynamics in the EU suggest a more complex system of rule-setting and governance than the simple, closed systems supported by the autopoiesis theory.<sup>10</sup> Many writers have offered various theories on the diffuse nature of EU governance, and thus, it could be argued that the cybernetic approach to analysing regulatory convergence is out of sync with the inherently

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<sup>9</sup> G Teubner, "After Legal Instrumentalism: Strategic Models of Post-Regulatory Law" in G Teubner, *Dilemmas of Law in the Welfare State* ( New York: Walter de Gruyter 1986); G.Teubner (ed), *Autopoietic Law: A New Approach to Law and Society* (Berlin Walter de Gruyter 1988), a useful synopsis is found in Arthur J Jacobson, "Autopoietic Law: The New Science of Niklas Luhmann" (1989) 87 Michigan Law Review 1647.. A critique of autopoiesis is found in Hugh Baxter, "Autopoiesis and the Relative Autonomy of Law" (1998) 19 Cardozo Law Review 1987 where it is argued that the level of autonomy in autopoiesis is not clear and subject to doubt.

<sup>10</sup> Orly Lobel, "The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought" (2004) 89 Minnesota Law Review 342.

diffuse nature of EU governance. Many commentators largely agree that the EU is characterised by a form of multi-level governance, espoused by Blank, Marks and Hooghe.<sup>11</sup> They argue that EU governance is a multi-level kind where many interactive layers of supranational, state and sub-state actors play a part in constituting the governance of an issue area. Cohen and Sabel call the EU a “deliberative polyarchy” which has a central framework in some respects but engages in a deliberative type of learning/decision-making process that is highly negotiative and intergovernmental in nature.<sup>12</sup> This heterarchical form of governance is without clear hierarchy and there are many and different centers of power, producing constant dialogue, negotiation and renegotiation,<sup>13</sup> and decentered processes of regulation and decision-making.<sup>14</sup> Commentators are however divided as to whether such pluralism in governance would remain or would move towards “deliberative supranationalism” as espoused by Joerges who believes that there would be a centralised form of EU governance in sight, only that it is constantly shaped by comitology dialogic influences across the EU.<sup>15</sup>

In view of the recent developments from the Treaty of Maastricht to Nice, it would also seem that there is political acknowledgement that EU governance should not pretend to be supranational and that much goes along the way of flexibility,<sup>16</sup> differentiated integration,<sup>17</sup>

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<sup>11</sup> G Marks, L Hooghe and K Blank, “European Integration from the 1980s- State-Centric vs Multi-Level Governance” (1996) 34 JCMS 341.

<sup>12</sup> “Sovereignty and Solidarity: EU and the US” in K Ladeur (ed), *Public Governance in the Age of Globalisation* (London: Ashgate 2004) at 157.

<sup>13</sup> Jo Shaw, “Process, Responsibility and Inclusion in EU Constitutionalism” (2003) 9 ELJ 45. Damian Chalmers also emphasises the dialogic aspects of EU governance as “deliberative” in nature, see “The Reconstitution of European Public Spheres” (2003) 9 ELJ 127.

<sup>14</sup> See generally Julia Black, “Constitutionalising Self-Regulation” (1996) 59 MLR 24, “Decentring Regulation” in (2001) Current Legal Problems 103, “Mapping the Contours of Contemporary Financial Services Regulation” (2002) 2 JCLS 253. See also Gunther Teubner, “Global Private Regimes: Neo-Spontaneous Law and Dual Constitution of Autonomous Sectors?” in Ladeur, (ed), *Public Governance* (2004), op cit at n12 at 71. Decentredness is a phenomenon where many actors are in a position to fashion norms and principles to govern certain social or economic areas of life apart from the State, a phenomenon that is increasingly possible because of globalisation and the shift of political action away from the monopoly of the state.

<sup>15</sup> C Joerges, “Deliberative Supranationalism- Two Defences” (2002) 8 ELJ 133.

<sup>16</sup> Introduced in the Treaty of Amsterdam, but the opt-outs from the euro allowed under the Treaty of Maastricht already foresaw this.

<sup>17</sup> Treaty of Amsterdam.

enhanced cooperation<sup>18</sup> and the open method of co-ordination.<sup>19</sup> The recognition that there is a need for “flexibility” and “differentiated integration” in the Treaties of the 1990s reflect the reality that there is a certain limit to a supranational way of governing in Europe. In fact, postmodernists such as Ian Ward have argued that the indeterminate but plural nature of EU governance is necessary as it reflects the inherent diversity of the EU, and an aspiration towards something simply more supranational and overarchingly “Europe” is in fact impossible<sup>20</sup> and may deny the very nature of “Europe” itself.<sup>21</sup>

This thesis submits that EU governance is a complex topic and the landscape of governance in different issue areas may be very dissimilar. Even if flexibility and pluralism in governance may be dominant in some areas, there are also issue areas of sufficient centralisation in direction and control. One example is in the administration of merger control where the Commission carries out centralised administration in vetting concentrations.<sup>22</sup> As EU securities regulation is now headed towards regulatory convergence, regulatory convergence is arguably a different direction from flexibility and differentiation. Thus, it is apt to study if regulatory convergence may amount to a system of governance in itself. As there are processes instituted for EU securities regulation that are unique to that area of governance, the cybernetic systems analysis may be aptly used to study these processes, to assess how they work in an autopoietic system towards the goal of regulatory convergence. Further, as regulatory convergence may be an autonomous system that can be achieved apart from the more fluid and diverse forms of governance in other issue areas in the EU, the cybernetic model of systems analysis is poised to provide a good benchmark to evaluate the

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<sup>18</sup> *ibid*

<sup>19</sup> Introduced for employment law co-ordination in the Treaty of Nice.

<sup>20</sup> Ian Ward, “The End of Sovereignty and the New Humanism” (2003) 55 *Stanford Law Review* 2091, and “Identity and Difference: The EU and Postmodernism” in J Shaw and G More (eds), *The New Legal Dynamics of the EU* (Oxford: Hart 1995).

<sup>21</sup> Jacques Derrida, *The Other Heading: Reflections in Today's Europe* (translated by Pascale-Anne Brault and Michael B Naas) (Bloomington: Indiana University Press 1992).

<sup>22</sup> Council Regulation 4064/89, On the Control of Concentrations Between Undertakings, 1989 O.J. (L 395)1, and comment by Earl Ray Beeman, “The EEC Merger Regulation- Preparing for a Common European Market” (1992) 19 *Pepperdine Law Review* 589.

prospects of achieving this. The cybernetic model supports assumptions of autonomy in systems, and as this thesis evaluates the regulatory convergence process against the cybernetic benchmark, it may become apparent if regulatory convergence is likely to amount to a cybernetic system of governance. Although the cybernetic model is a high benchmark, the evaluation of EU securities regulation convergence against that may highlight where the “shortfalls” may be and to what extent the shortfalls may affect convergence.

There are other theories that seek to study systems, such as “complexity theory”.<sup>23</sup>

Complexity theory posits that all systems are complex, and the actors within each system affect each other in a number of ways that may be captured within the 10 principles of complexity, such as path dependence, connectivity and co-evolution. This thesis does not suggest that other systems theories may be unsuitable to evaluate the prospects of regulatory convergence. Theories like complexity may be employed to study how each actor within the regulatory convergence system affects other actors, and how the interaction or environment for interaction between the actors can be modified to provide self-enhancements within the system to improve the system. Indeed a theory such as complexity may become relevant if the conclusion is that a cybernetic system in regulatory convergence is unlikely and that convergence by stealth needs to be fostered. This thesis is of the view that it would be apt to examine the systemic structure of regulatory convergence first, to evaluate it at a macro level, examine its processes and evaluate the prospects that the systemic structure may entail. If the conclusion is that regulatory convergence is unlikely to be fostered based on the systemic structure of its framework and processes, then regulatory convergence may have to be accepted as a more fluid type of arrangement, and micro studies into the actors may then entail insights into how regulatory convergence by stealth may be achieved by examining the dynamics of actor relationships. However, that is beyond the scope of this thesis.

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<sup>23</sup> Eve Mitleton-Kelly, *Complex Systems and Evolutionary Perspectives on Organisations: The Application of Complexity Theory to Organisations* (London: Elsevier 2003) at ch 2.



## The Cybernetic Model

Briefly, the cybernetic model assumes that where certain objectives are to be achieved, a system would exist to direct towards the achievement of those objectives. The system consists of a “*selector*” which provides for the norms or principles for the system. The *selector* would also provide (or *transduct*) direction or control over actors (*effectors*) within the system, that would put into practice the norms of the system to achieve the objectives of the system.<sup>24</sup> The roles of the *selector* and *effector* can be undertaken by institutions, collective actors or individuals. In turn these actors observe and gather information as the system performs, in order to create a feedback loop to provide modification insight into future direction, in order to direct towards achieving the original objectives. Applying the theory to regulatory systems, a regulatory model which is cybernetic should have the following components:<sup>25</sup> norm-setting for the entire system, control over the execution of the norms in order to attain the objectives of the system, information-gathering by observing and measuring the performance of the system, and securing compliance (this author notes that compliance is a broader concept than mere enforcement.)<sup>26</sup>

First, this chapter will apply the benchmark of the cybernetic model to evaluate regulatory convergence in the sources of law in securities regulation. It will be concluded that there is a lack of convergence in the sources of law in EU securities regulation. This is because the primary Directives give rise to multiple national laws whose content may vary, and there is a

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<sup>24</sup> Rejean Landry and Vincent Lemieux, “L’analyse cybernetique des politiques gouvernementales” (1978) 11(3) Canadian Journal of Political Science 529.

<sup>25</sup> J Black, “Enrolling Actors in Regulatory Systems: Examples from UK Financial Services Regulation” (2003) Public Law 63, and “Critical Reflections on Regulation”(2002) 27 Australian Journal of Legal Philosophy 1.

<sup>26</sup> C Hood, H Rothstein and R Baldwin, *The Government of Risk: Understanding Risk Regulation Regimes* (Oxford: Oxford University Press, 2001), on methodologies for securing compliance, see R Kagan and J Scholz, “Regulatory Enforcement Strategies” in K Hawkins and J M Thomas (eds), *Enforcing Regulation* (Kluwer-Nijhoff, Boston, Mass., 1984), Karen Yeung, *Securing Compliance* (2003), op cit at n1.

lack of control in securing convergence over the content of national laws. The analysis is as follows.

## **2. Convergence in Sources of Law**

The first aspect of regulatory convergence to be discussed is convergence in the sources of law for EU securities regulation.

### ***2.1 Law-making Process in the EU***

The law-making process for substantive securities regulation was, until the Lamfalussy Report, the general process for law-making in the EU.

This thesis will describe briefly the general law-making process in the EU in order to highlight the changes brought about by the Lamfalussy procedure. The EU institutional framework consists of a number of institutions. First, the European Council, which is a meeting of the Heads of State held every quarter to provide guidance on the direction of EU policies. This “meeting” was not originally institutionalised in the Maastricht or Amsterdam Treaties, but its *de facto* influence is considerable. Furthermore, the certainty with which the meetings take place lends it an institutional character.<sup>27</sup> The next institution of considerable importance is the Council of Ministers. This Council is a permanent outfit consisting of representatives of Member States. The Council makes decisions on EU policies and also initiates legislation. The law-making powers of the Council have been cut back somewhat by the co-decision procedure introduced in the Amsterdam Treaty for the benefit of the European Parliament, so that law-making is to be undertaken jointly between the Council and

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<sup>27</sup> For a brief discussion, see Neill Nugent, *The Government and Politics of the European Union* (London: Macmillan 1999, 4<sup>th</sup> ed) at ch8.

Parliament. The Parliament consists of representatives elected by universal suffrage in Member States to represent citizenry interests and to have law-making powers. The European Commission is akin to the Executive arm of the EU in that it is responsible for initiating legislative proposals, and is also responsible for the management of EU policies in their implementation in Member States. It also supervises the implementation in Member States of EU laws and is able to take enforcement action against errant States. The Commission consists of appointed members ensuring a fair representation of States, but it is more supranational in character as the Commission is to act independently of national interests in order to further EU interests as a whole. The appointed members are generally competent in the areas of Treaty competences where the EU may legislate or provide direction.<sup>28</sup> The European Court of Justice ensures the implementation of Treaty provisions by the doctrines of direct application (i.e. that no further act on Member States' part to make the law binding on them is required) as well as direct effect,<sup>29</sup> i.e. EU law is capable of giving rise to rights for individuals to enforce against Member States if Member States fail to implement them, and giving rise to remedies such as compensation, if such an individual has suffered loss.<sup>30</sup> The Court is open to Member States, institutions of the EU, and natural and legal persons. Thus, it is a forum for EU law to be enforced, upheld and interpreted.

Law-making in securities regulation is pursuant to the Treaty competence to complete the internal market,<sup>31</sup> based on the freedom of movement of capital.<sup>32</sup> First, the law may be initiated by the European Commission. This law must then be adopted by the Council of

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<sup>28</sup> The competencies of the EU are expressly conferred and not to be exceeded, as Member States are still regarded as sovereign states with all the natural competencies flowing from statehood as regards to governance of themselves. See Article 7, EC Treaty, and Anthony Arnall et al, *Wyatt and Dashwood's European Union Law* (London: Sweet and Maxwell 2000 4th ed) at 153.

<sup>29</sup> Case 32/84, *Van Gend en Loos v Nederlandse Belastingadministratie* [1964] CMLR 423.

<sup>30</sup> Joined Cases C-6/90 and C-9/90, *Francovich and Bonifaci v Italy* [1991] ECR I-535.

<sup>31</sup> The European Court has actively enforced the Internal Market principle, see Case 120/78, *Cassis De Dijon*, [1979] ECR 649; [1979] CMLR 49, that upheld a principle of mutual recognition of goods produced in one Member State, in other Member States, based on the Treaty competence of Article 3. However, Case C-376/98, *Germany v European Parliament* [2000] ECR I-8419, has provided a caveat to the parameters of legislating for the internal market.

<sup>32</sup> Article 56 of the Treaty of Rome.

Ministers, and now, co-decided by the European Parliament.<sup>33</sup> The legislative instruments that may be utilised are Regulations, which are directly binding and applicable to Member States, or Directives, which set out the substantive results that Member States cannot derogate from, but these Directives would only take effect in Member States upon the implementation of the Directives into national law. There may be room for Member States to provide for additional or other requirements that are not contained in the Directives.<sup>34</sup> The formulation and implementation of laws would also be underpinned by comitology procedures which compel the Commission to consult and discuss with the committees of experts within the Commission on particular subject areas regarding the formulation of substantive laws.<sup>35</sup>

All substantive securities regulation in the EU has been formulated using the legislative framework above, and in order to accommodate different Member States' interests in domestic financial regulation, the legislative instrument used to enact EU securities laws has always been Directives.<sup>36</sup> The Lamfalussy report<sup>37</sup> has identified several weaknesses in the use of Directives for completing the Internal Market. It has been acknowledged that the law-making process for securities regulation has been too slow, as Directives generally take a few years to enact, and then take another few years to be implemented in Member States. By the time of implementation (if implemented at all), market practices and needs may have changed and it may be time to reform the laws again.<sup>38</sup> Directives also allow Member States to impose additional requirements that may become barriers to cross-border activity, affecting the

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<sup>33</sup> Treaty of Amsterdam.

<sup>34</sup> See generally, Anthony Arnall et al, *Wyatt and Dashwood* (2000), op cit at n28.

<sup>35</sup> Andrea M Corcoran and Terry L Hart, "The Regulation of Cross-Border Financial Services in the EU Internal Market" (2002) 8 *Columbia Journal of European Law* 221, for a summary of the law-making process in the EU.

<sup>36</sup> Antonio Sainz de Vicuna, "The Legal Integration of Financial Markets of the Euro Area" (2001) 12 *EBLR* 223 argues that Member States prefer Directives as they would be less restricted in their political choices.

<sup>37</sup> Lamfalussy report at 14 ff.

<sup>38</sup> Sainz de Vicuna (2001) op cit at n36 at 236 and the Lamfalussy report at 14.

integration of the internal market.<sup>39</sup> The general law-making system in the EU is an arrangement that sits somewhere between federalism and international treaty obligations.<sup>40</sup>

EU securities regulation that is the product of general law-making tends to be fragmented and insufficiently unified. The use of Directives inherently allows regulatory fragmentation in the transposition process,<sup>41</sup> giving rise to a phenomenon of “multiversalism” in sources of law.

## 2.2 *Multiversalism in Sources of Law*

EU legislation that is in the form of Directives, have direct effect on Member States but need to be effected through national transposition. This is in line with the proportionality requirement found in the Treaty of Rome.<sup>42</sup>

National transposition gives rise to many sets of national laws emanating from the primary EU Directive, producing “multiversal” norms of the same subject matter. “Multiversal norms” is a term coined in this thesis by analogical reference to the idea of the “multiverse” espoused by Sir Martin Rees.<sup>43</sup> Rees’ conception of the universe is that there may not be one universe, but a series of parallel universes which we cannot detect, and this coheres with the parallel realities espoused by the theory of quantum mechanics, which to put most simplistically, is a theory that says that there could be parallel and opposite realities of a same

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<sup>39</sup> See Alexander B St John, “The Regulation of Cross-border Public Offerings of Securities in the European Union: Present and Future” (2001) 29 *Denver Journal of International Law and Policy* 239 for a brief overview of the pre-reform securities regulatory framework.

<sup>40</sup> The nature of EU governance has been subject to much academic discussion, with writers doubting its constitutionalism, and writers describing it as an emerging form of procedural governance, see J Weiler, *The Constitution of Europe-Do the New Clothes have an Emperor and Other Essays on European Integration* (Cambridge: Cambridge University Press 1999) at chs 6 and 7; “A Constitution for Europe? Some Hard Choices” in J Weiler, Iain Begg and John Peterson (eds), *Integration in an Expanding European Union-Reassessing the Fundamentals* (London: Blackwells 2004) at 17ff. See also Jo Shaw, “Process, Responsibility and Inclusion in EU Constitutionalism” (2003) 9 *ELJ* 43, and Antje Weiner, “Editorial: The Evolving Norms of Constitutionalism” (2003) 9 *ELJ* 1.

<sup>41</sup> Lamfalussy Report at 14ff, and see Jan Andersson, “The Regulatory Technique of EU Securities Law- A Few Remarks” (2003) 14 *EBLR* 313.

<sup>42</sup> Article 3b, Treaty Establishing the European Community.

<sup>43</sup> Martin Rees, *Our Cosmic Habitat* (London: Weidenfield and Nicholson 2001).

event that is happening concurrently and what we know as “fact” is only the experience of one of these realities.<sup>44</sup> To use the idea of the multiverse analogically, in the area of EU Directives, the Directives are regarded as law at EU level, but these Directives need national transposition, and where Member States are concerned, the actually applied and enforced law is the nationally transposed version, which may or may not be on all fours with the Directive, as long as the equivalent result is achieved. Although the parallel national laws do not amount to multiverses that may not be detected, they are “multiversal” in nature as they are parallel and none is superior to any other. EU Directives produce many sets of parallel laws, all subsisting alongside each other and equally effective, as no one Member State’s interpretation is binding on another Member State’s courts. Although there is a certain superiority of the European Court’s jurisprudence which could pronounce a Member State as not being compliant in transposition,<sup>45</sup> the Court cannot dictate the shape of actual transposition. Directives therefore by nature lend themselves to the proliferation of multiversal norms and thus, from the perspective of supranational governance, there is always “inherent fragmentation” in national transposition. Even in the traditional “Community method” of norm-creation at an EU level, the Directive is a compromise between the supranationalism of EU law-making and the preservation of legislative sovereignty in Member States, so that inherent differentiation and national divergences are already allowed. It is likely that each Member State would not produce exactly the same multiversal norms, as the textual law is likely to be adapted into national law, reflecting the colour and culture of national law.<sup>46</sup>

On the other hand, it may be argued that Directives do not produce multiversal norms, in that national laws are not strictly speaking, “multiversal”, as if they exist in parallel universes and

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<sup>44</sup> John Gribbin, *In Search of Schrodinger’s Cat: Quantum Physics and Reality* (London Bantam Books 1984)

<sup>45</sup> Article 226 of the Treaty of Rome.

<sup>46</sup> Ulrich Haltern, “Integration Through Law” in Antje Wiener and Thomas Diez (eds), *European Integration Theory* (Oxford: Oxford University Press 2004) at 177ff.

never interact with or influence each other. The EU is served by a common European Court of Justice which could provide common constitutional review and interpretation of EU laws under the preliminary reference procedure in Article 234 of the Treaty of Rome. The preliminary reference procedure allows a national court uncertain of how to interpret a particular EU law to refer it to the Court for a preliminary ruling. Even though technically speaking, only that national court and its subordinates are bound by the ruling, a fellow court in another Member State faced with a similar issue may consider such interpretation very persuasive and regard such interpretation as a supranational precedent.<sup>47</sup> However, interpretive guidance from the European Court and individual non-transposition proceedings against Member States are piecemeal and *ad hoc* in nature and merely tweak rather than dictate the shape of national transposition. Thus, national transposition is largely delegated to Member States, and national laws produce multiversality in the sources of law for the issue area concerned.

For example, under the old Insider Dealing Directive,<sup>48</sup> the Directive's failure to deal with the issue of civil liability for insiders spawned major differences in national transposition. Many civil law jurisdictions provided civil liability through tortious actions available under general law,<sup>49</sup> while most of the Nordic jurisdictions including Denmark merely had criminal sanctions.<sup>50</sup> The UK has a very limited civil liability regime in terms of the common law of misrepresentation or negligence, and a statutory provision allowing individuals to sue only authorised intermediaries for breaches of statutory duty, which could arguably include market

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<sup>47</sup> Much writing has been proffered in the area of judicial dialogue, cross-fertilisation of judicial precedent and creation of a judicial community, whether at EU or international level. See Anne-Marie Slaughter, "A Global Community of Courts" (2003) 44 *Harvard International Law Journal* 191.

<sup>48</sup> Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing OJ 1989 L334/30.

<sup>49</sup> See Emilio Avgouleas, *The Mechanics and Regulation of Market Abuse* (Oxford: Oxford University Press 2005) at 294.

<sup>50</sup> Jesper Lau Hansen, "The New Proposal for the European Union Directive on Market Abuse" (2002) 23 *University of Pennsylvania Journal of International Economic Law* 241.

abuse.<sup>51</sup> A commentator noted that the existence of civil liability for insider dealing affects the attractiveness of capital markets, especially for American investors.<sup>52</sup> To an American investor, the UK would be regarded as having a different system of investor protection, from France or Denmark, although the laws on insider dealing emanate from the same Directive.

In this round of securities regulation reforms, a new law making process has been instituted following the Lamfalussy report.

### *2.3 Law-Making under the Lamfalussy Report*

The Lamfalussy report identifies a four-level procedure that may be used in securities regulation in order to fast-track law-making. Level One relates to identifying general framework principles that would be enshrined in Regulations. The Commission would identify these after consultation and would submit these to be jointly endorsed by the European Parliament and Council of Ministers.

At Level Two, the Commission would be delegated the responsibility to produce technical measures to supplement the gaps left by the Regulations, but these technical measures would merely flesh out the details left to be elaborated. The Commission has to obtain in principle endorsement of Level Two measures from the Council and Parliament, and it is envisaged that Level One principles would specify the Level Two measures that are delegated. However, Member States are wary of using Regulations and have opted for Directives instead. As for Level Two measures, both the Council and the European Parliament are wary of the powers delegated to the Commission. Thus, a resolution<sup>53</sup> has been made in Stockholm such that the

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<sup>51</sup> n49 at 391ff.

<sup>52</sup> Viveca Hostetter, "Turning Insider Trading Inside Out in the European Union" (1999) 30 California Western International Law Journal 175.

<sup>53</sup> Discussion of the Commission's "constraints" are found in John F Mogg "Regulating Financial Services in Europe: A New Approach" (2002) 26 Fordham International Law Journal 58, and Niamh Moloney, "The



Commission would not adopt a measure with which the Council has strong disagreements. The Parliament bargained for a call-back clause on the Commission's Level Two measures but this was not granted. Although the veto clause failed, the Parliament still may have scrutiny over Level Two measures which must be submitted to the Parliament. In practice, the Commission seeks Parliament consent to the draft Level Two measures before promulgating them. The Parliament has however the power to set a sunset clause on the Commission's powers i.e. to stipulate an expiry date for the Commission to come up with Level Two measures so that Level Two measures cannot be enacted as and when the Commission pleases.

Level Two measures also require the Commission to seek advice from the Committee of European Securities Regulators<sup>54</sup> (CESR) before initiating legislation, with the agreement with the European Securities Committee (ESC) which consists mostly of finance ministers of Member States. CESR would produce the groundwork for the Level Two legislation. CESR itself has produced a charter and statement to be committed to consulting with the needs of market players and investors.<sup>55</sup> The work produced by CESR would then have to be voted upon by the ESC and a qualified majority would allow the Commission to initiate the Level Two legislation.

Level Three measures relate to the cooperation between national authorities of Member States in implementing the Directives and Level Two measures. Coordination in legislative interpretation, application and regulatory policies is expected to be achieved by cooperation between Member State authorities under the umbrella of CESR.

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Lamfalussy Legislative Model: A New Era for the EC Securities and Investment Services Regime” (2003) 52 ICLQ 499.

<sup>54</sup> CESR consists of all of the securities regulators of all Member States. See [www.cesr-eu.org](http://www.cesr-eu.org).

<sup>55</sup> [www.cesr-eu.org](http://www.cesr-eu.org).

Level Four measures reflect the general rule of enforcement at the EU level for non-compliant states, that Member States should be rigorous in ensuring they comply with the Directives and Level Two measures. If Member States fail to implement the Directives and Level Two measures, the Commission may invoke Article 226 of the Treaty and submit them to the enforcement powers of the European Court of Justice.

## *2.4 The Lamfalussy Procedure and its Implications on Sources of Law*

### *2.4.1 Multiversalism in National Transposition*

As Level One laws are in the form of Directives, the old issue of multiversalism in national transposition remains. An example of such multiversalism at work is seen in the national transposition of the Market Abuse Directive in the UK and Germany. For example, Germany and the UK have slightly different definitions of market abuse. The German definition follows the Directive in providing for insider dealing and market manipulation separately, and not under a general “market abuse” provision, unlike in the UK. Germany defines market manipulation with reference to specific acts of non-disclosure, false or misleading disclosure.<sup>56</sup> The UK definition of market abuse is wider than the Directive’s as it includes any form of market behaviour that regular users of the market would regard as distorting the market in that investment instrument in question.<sup>57</sup> The Financial Services Authority’s Handbook on Market Conduct has classified 7 areas of market abuse which are arguably similar to the scope of the German AnSvG,<sup>58</sup> although the primary legislation potentially allows the introduction of other categories of abusive behaviour in the future. The FSA Handbook also emphasises on the potential of *acts* creating a result of market manipulation,

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<sup>56</sup> Section 20, AnSvG.

<sup>57</sup> Sections 118, 119 and 123 of the UK Financial Services and Markets Act 2000. The difference between the UK version and the Directive is also highlighted in Emilio Avgouleas, *The Mechanics and Regulation of Market Abuse* (Oxford: Oxford University Press 2005) at 343.

<sup>58</sup> See FSA Handbook on Market Conduct, available online at [www.fsa.gov.uk](http://www.fsa.gov.uk). Also, s20a of the German AnSvG.

rather than merely disclosure or the lack thereof.<sup>59</sup> Further, there are only administrative sanctions for market manipulation in the UK,<sup>60</sup> but there are criminal and administrative sanctions for market manipulation in Germany depending on the degree of intent of wrongdoing and whether the manipulative disclosure or lack thereof actually influenced market price.<sup>61</sup> This in fact results in Germany having a dual system of market manipulation and the UK having only a singular system.

Multiversalism is arguably antithetical to regulatory convergence, as it allows decentralisation of sources of law, and hence, divergence in the content of the laws as well. In cybernetic terms, multiversalism results in many locations of norm-production, and therefore, it introduces a multitude of *selectors* into the cybernetic system analysis. The multitude of *selectors* does not necessarily mean that the norms cannot be clearly and orderly set.

However, the clarity and orderliness of norm-setting depend on the existence of procedural rules that govern the relationship between the plural locations. In the multiversalism of national transposition, each multiversal set of norms is arguably parallel and equal, as Member States are equally sovereign, and thus, there is no meta-procedural rule that could organise the decentralised sources of law into a coherent whole. While there may be a form of limited harmonising control exercised by the European Court, such control as discussed, is piecemeal and *ad hoc* in nature, and does not significantly change the divergent nature of sources of law and the resulting divergent content of the laws. The multitude of *selectors* allowed by the use of Directives is unlikely to satisfy the norm-setting aspect of a cybernetic system.

A multitude of *selectors* may also mean divergence in the ultimate objectives of regulation. Where *selectors* are diverse, the *transduction* or direction of control which is provided by

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<sup>59</sup> FSA Handbook on Market Conduct, see MAR 1.4-1.9.

<sup>60</sup> above at n48.

<sup>61</sup> Sections 20, 38 and 39 of the AnSvG.

different *selectors* may be diverse. Convergence requires a sufficiently high amount of “control” within the EU securities regulatory system to ensure that the transposition and application of norms throughout the EU is even. It may be argued that the general principle that the effects of a Directive must be achieved in national transposition is sufficient to amount to “control” in a cybernetic system. But that would be saying that national transposition and regulatory convergence are no different, which is probably not the case. Regulatory convergence may be assumed to be of a higher threshold than mere achievement of effects under national transposition. At present, national transposition is a national matter, and because multiversalism gives rise to diverse *selectors* in norm-setting, there is no cybernetic control over the *ex ante* production of national laws. There is no compulsory input of pan-EU perspectives or vetting of national legislation at the EU level. However, one may argue that the work of Level Two measures or of CESR at Level Three, amount to a form of EU-level “control”. The aspects of the substantive law that will give rise to multiversalism will be discussed, after which the discussion will be returned to Levels Two and Three of the Lamfalussy procedure to see if these two levels provide any form of control over the divergence in sources and content of the laws.

#### *2.4.2 Gaps in Substantive Law and Room for National Divergences*

Multiversalism in national transposition is likely to be augmented if the substantive law in the Directives provides for discretionary implementation by national laws and regulators. As the language of the law may not be closed, importing always only of one possible interpretation, discretionary terms used in the Directives may be implemented or interpreted in divergent ways across the Member States. Some examples are discussed:

#### *Interpretation of Terms*

Various terms in the Directives may be subject to different discretionary interpretation by national regulators. As mentioned, the UK and Germany define and treat market abuse rather differently. There is some effort on the EU level to provide for uniform interpretation of market manipulation, but there is still room for Member States to diverge.

The example dealing with market manipulation is as follows. One of the definitional limbs in the Market Abuse Directive states that market manipulation may be found if a person secures the price of a financial instrument at an “artificial and abnormal” level.<sup>62</sup> As the term “artificial and abnormal”, in terms of prices, is prone to interpretational divergences,<sup>63</sup> Level Two measures have sought to close the divergence gap. Article 4 of the Commission Directive supplementary to the Market Abuse Directive<sup>64</sup> provides some clarification by relating to significant proportion of volume of trades, or significant shifts in price. However, “significant” may itself be indeterminate and may change as investor behaviour changes, and movements in price *per se* may not be incriminating if such movements fulfill the efficient capital markets hypothesis. Different markets with different levels of trading maturity may also regard “significant” differently. Thus, the gap for divergence cannot be definitively closed. In general, Member States may also create exceptions to market abuse. Examples of commonly exempted transactions are price stabilisation,<sup>65</sup> buy-backs and certain forms of short selling. As Member States may allow different exemptions and accepted market practices, this would likely create fragmentation amongst Member States as in their implementation of market abuse regulation.<sup>66</sup> CESR has sought to collect and put on its

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<sup>62</sup> Article 1(2)(a). Some observations about why market manipulation is regulated may be found in Steve Thel, “\$850,000 in Six Minutes: The Mechanics of Securities Manipulation” (1994) 79 Cornell Law Review 219.

<sup>63</sup> Michael McKee, “The Proposed Market Abuse Directive” (2001) 3(4) JIFM 137.

<sup>64</sup> 2003/124/EC OJ L339/70.

<sup>65</sup> Price stabilisation is a useful technique for underwriters just after the initial offering of shares. Shares may be bought in large quantities so as to keep the price from falling. See Steve Thel, “Regulation of Manipulation under Section 10(b): Security Prices and the Text of the Security Exchange Act of 1934” (1988) Columbia Business Law Review 359 at 430. The UK FSA will not regard price stabilisation as market abuse within certain criteria. See FSA, *Public Issues of Securities and Stabilisation* (March 2005), available at [www.fsa.gov.uk/pubs/public/stabilisation.pdf](http://www.fsa.gov.uk/pubs/public/stabilisation.pdf), (accessed July 2006).

<sup>66</sup> Critique against the gaps in the Market Abuse Directive with respect to “market manipulation” may be found in Alistair Alcock, “Market Abuse” (2002) 23 Company Lawyer 142.

website information regarding Member States' accepted market practices not amounting to market abuse, however, such centralisation of information does not mean streamlining of Member State practices.

However, there are also efforts made at prescribing in such detail that all discretionary gaps by national regulators may be closed. Under the MIFID, post-trade reporting needs to be done "in a reasonable commercial manner, as close to real-time as possible".<sup>67</sup> It is possible that what "reasonable commercial" is, may be subject to interpretational difficulties as different markets may have different expectations,<sup>68</sup> and there can be some discrepancy as to what "close to real-time" is between Member States. The MIFID Commission Regulation<sup>69</sup> has closed the interpretive gap by prescribing that "as close to real time as possible" means 3 minutes of the close of trade, or the next trade opening day if a trade was executed after hours. This is an example of detailed prescriptive regulation that is required to close all possible interpretive gaps. However, in spite of this, Member States have lobbied for an exception to the real time reporting rule. Member States that have quote-driven markets are more unwilling to report real time trades so as to protect the anonymity of market-markers who may have just concluded a large trade with an investor. As such, the MIFID allows deferral of reporting subject to some conditions. The MIFID Commission Regulation tries to define the conditions specifically with respect to "large trades",<sup>70</sup> and what may be considered a large trade for different categories of shares are set out in great detail in Tables 2, 3, and 4 of Annex II.

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<sup>67</sup> Articles 20, 28, 30 and 45.

<sup>68</sup> The Club Med countries may be more used to immediate transparency than the North Sea jurisdictions. See Eddy Wymeersch, "Control of Securities Markets in the European Economic Community", in 'Commission of the European Communities, Collection Studies, Competition Approximation of Legislation Series No 31 (1978), quoted in L Gharzaniti, "Single Market-Making- EC Regulation of Securities Markets" (1993) 14 Company Lawyer 43 .

<sup>69</sup> Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive (MIFID Commission Regulation).

<sup>70</sup> Articles 28, 33 and 34.

A similar approach is taken in terms of pre-trade transparency requirements. The MIFID allows national regulators the discretion to waive pre-trade transparency reporting according to the 5 best bid/offer benchmark laid down in Article 17 of the Commission Regulation. However, Article 18 constrains the discretion to waive by requiring the fulfilment of specified conditions. Hence, the room for regulator discretion is arguably very small. Despite tight regulatory prescriptions that could be set out in Level Two measures, it would be impossible to close every regulator discretion gap without the Commission over-prescribing and producing a flood of legislation.<sup>71</sup> Hence, where regulator discretion is allowed, national divergences may still occur. It may even be argued that precisely because of the prescriptive nature of some aspects of the Directives, where regulators find freedom to exercise discretion, they may all the more seize the opportunity to do so.

### *Application of Discretion by Regulators*

Major uses of regulator discretion are found in the authorisation regimes for prospectuses,<sup>72</sup> market operators<sup>73</sup> and management personnel in investment firms.<sup>74</sup> Where the Prospectus Directive is concerned, as Commission Regulations and CESR's recommendations have provided extensively for the contents of a prospectus, the discretion to approve or disapprove a prospectus may be constrained by such Level Two and Three measures, which will be discussed. Where authorisation of investment firms and markets are concerned, there is more room for discretion. For example, for management personnel of investment firms, the regulator must be satisfied as to their "sufficiently good repute" and "sufficient experience".<sup>75</sup> These terms are subject to likely interpretational differences, and no guidance is given as to whether persons related to a previously insolvent firm may be approved, or persons who may

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<sup>71</sup> Jean-Pierre Casey and Karel Lannoo, "The MIFID Implementing Measures: Excessive Detail or Level Playing Field?" CEPS Working Paper No. 1, May 2006, at [www.ceps.be](http://www.ceps.be) (accessed Oct 2006).

<sup>72</sup> Article 13, Prospectus Directive.

<sup>73</sup> Art 37, MIFID.

<sup>74</sup> Art 9, MIFID.

<sup>75</sup> Ibid.

have been disqualified directors under national legislation. “Sufficient experience” begs the question that where firms or market operators are seeking approval for the first time, what would the regulator’s discretion be based on to determine if approval is to be given?<sup>76</sup>

Another example is that investment firms operating MTFs need to institute “transparent rules” and “objective criteria” for their operations and procedures.<sup>77</sup> However, the content of these rules and criteria are not prescribed and hence, it is conceivable that home regulators may have different rules for the MTFs they oversee.<sup>78</sup> Further, although the MIFID does not stipulate that MTFs need permission to operate, and could be set up as part of an investment firm’s business, the FSA requires MTFs to seek permission.<sup>79</sup> Hence, regulators are able to introduce subtle differences in the interpretation of textual laws.

### ***Reasons for Interpretational Differences***

On a higher level, interpretational differences may result because regulator discretion in interpretation may not only be due to the allowances of discretion inherent in the language of the Directives, but to the fact that regulator discretion may be influenced by various domestic, political or bureaucratic forces.

Most Member States have a single integrated regulator for all financial activity, but some single regulators are part of the central bank, such as in Estonia, and may not be totally independent. Some Member States have functional regulators such as the French AMF and Greek CMC. There are also sectoral specific regulators such as Czech Securities Commission, the Italian Consob as well the Polish and Lithuanian Commissions.<sup>80</sup> Thus, although the

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<sup>76</sup> The UK has its own assessment criteria of “fit and proper”, see FSA Handbook on “High Level Standards” at FIT2.

<sup>77</sup> Article 14, MIFID.

<sup>78</sup> FSA Handbook on Market Conduct at MAR 5.5.

<sup>79</sup> FSA Handbook on Market Conduct at MAR 5.

<sup>80</sup> Information regarding regulators can be found on CESR’s website, [www.cesr-eu.org](http://www.cesr-eu.org) which provides links to all Member State regulators’ websites.



responsible regulator can be identified quite easily, the degree of independence, scope of remit and extent of powers and resources may vary considerably.

A detailed comparison of the differences in structure and operations of Member State regulators is beyond the scope of this thesis. However, a few brief points may be made in comparing a few independent single regulators. Independent single regulators may differ in terms of authority, independence, resources and accountability. For example, the UK and Germany have integrated financial markets regulators in the form of the Financial Services Authority (FSA) and the Federal Financial Supervisory Authority (BaFin). However the extent of governmental influence in either agency differs. The FSA is accountable to the government and Parliament by reporting, and there is some limited government input into the FSA's decision-making processes. The HM Treasury is able to appoint the chairman of the non-executive committee of the FSA board, but the mandate of the Chairman is specific and does not influence the decisions of the FSA in its regulatory role.<sup>81</sup> The BaFin is also accountable to the government by reporting, but much more *ex ante* government input could be channeled into the BaFin's regulatory decisions as the government could establish a Securities Council comprising of ministerial representatives to advise BaFin and even to delineate the regulatory functions that ought to be carried out by BaFin and the stock exchanges.<sup>82</sup> The apparent similarity of independent single regulators disintegrates upon closer scrutiny. Independent single regulators, such as in the UK, Germany and the Nordic jurisdictions, have been through different historical passages which may result in differences in the operations and structures of these regulators. The FSA in the UK, the BaFin in Germany and the Finanstilsynet in Denmark are all institutions combining previous regulatory institutions in sector-specific areas. These institutions continue to allow internal

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<sup>81</sup> See FSA's website, [www.fsa.gov.uk](http://www.fsa.gov.uk), and discussion in Alan Page, "Regulating the Regulator" in E Ferran and CAE Goodhart (eds), *Regulating Financial Services* (Oxford: OUP 2001) at 127.

<sup>82</sup> Securities Trading Act (9 Sep 1998) found on the BaFin website, [http://www.bafin.de/gesetze/wphg\\_en.htm#p4](http://www.bafin.de/gesetze/wphg_en.htm#p4).

departmental divisions along old sectoral lines while defining themselves as single regulators ready for the integrated and complex nature of financial markets.<sup>83</sup> The various domestic, bureaucratic and political structures surrounding regulators are likely to influence regulators in going into divergent directions.

Further, according to various regulation theories, national regulators are influenced by pressures that could lead them into divergent directions. According to the “public choice” theory, regulators are interested in augmenting their domestic turf. Thus, wider EU convergence may not feature heavily in a regulator’s priorities.<sup>84</sup> Alternatively, the economist Stigler has suggested that national regulators respond to regulatory capture by significant interest groups, and would take steps to protect those interests instead of the wider picture of convergence.<sup>85</sup> Regulators may also operate in different “regulatory cultures”. For example, the “principles-based” approach to regulation in the UK which dominated the UK financial regulation landscape before the establishment of the Financial Services Authority, was very much based on contact and exchange between regulators and practitioners, and light-touch regulation coupled with self-policing efforts. Regulation was based on general principles, values and the ethos of the industry “club”.<sup>86</sup> Although the creation of the FSA has brought about a change to rules-based regulation, the FSA has opined that there are many virtues of the principles-based approach that ought to be carried on and co-opting practitioners is still

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<sup>83</sup> Eilis Ferran, “Examining the United Kingdom Experience in Adopting the Single Financial Regulator Model” (2003) 28 *Brooklyn Journal of International Law* 257; Mads Andenas and Jens-Hinrich Binder, “Financial Market Regulation in Germany: The New Institutional Framework” and Jesper Lau Hansen, “A Path-Dependent Route towards a Single Financial Regulator: The Experience of Denmark” in M Andenas and Y Avgerinos (eds), *Financial Markets in Europe* (The Hague: Kluwer Law International 2003) at 359 and 447.

<sup>84</sup> A commentator suggested that theories such as public choice ought to be looked at in terms of actual administrative practices and procedures. The presence of procedures that constrain a department’s decision-making autonomy may indicate that theories such as public choice are not reflective of the actual regulatory practice, Steven P Croley, “Theories Of Regulation: Incorporating The Administrative Process” (1998) 98 *Columbia Law Review* 1.

<sup>85</sup> George Stigler, “The Theory of Economic Regulation” (1971) 2 *Bell Journal of Economics and Management Science* 3. However, see Croley, *ibid*, who suggests looking at whether there can ever be such a significant and unified lobby group, given the need to put resources into organising such a group and the difficulty in achieving group consensus.

<sup>86</sup> Brian Quinn, “The Influence of the Banking Acts (1979 and 1987) on the Bank of England’s Traditional Style of Banking” in Joseph J Norton (ed), *Supervision, in Bank Regulation and Supervision in the 1990s*, (London: Sweet and Maxwell 1991) at 1.

being carried out.<sup>87</sup> This is different from the rules-based approach taken in the EU Directives which prescribe much detail such as in prospectus disclosure<sup>88</sup> or under the MIFID.<sup>89</sup> These differences may amount to much, as the styles of supervision, enforcement and general administration will give rise to differences in the perception of the regulated in their contact with regulators throughout the EU.

Finally, another reason why divergent administration may be carried out by regulators is that regulators may interpret the Directives as providing for a minimum harmonisation model and not regulatory convergence. Although the Lamfalussy Report identifies the need for regulatory convergence in EU securities regulation,<sup>90</sup> the substantive laws have provided for conflicting signals. Further, the phenomenon of multiversalism in sources of laws allows regulators to act on these conflicting signals. The most prominent example of minimum harmonisation is found in the Transparency Directive.

### ***Minimum Harmonisation***

The Transparency Directive endorses minimum harmonisation explicitly. An absence of convergence is inherent in such minimum harmonisation, as Member States are free to impose additional requirements. The Transparency Directive provides for the continuous disclosure obligations of publicly traded corporations in the EU, to be in yearly or half-yearly financial reports and interim management statements.<sup>91</sup> These obligations are expressly stated to be minimum requirements and Member States are free to impose more stringent

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<sup>87</sup> John Eatwell, "Financial Services Regulation: Lessons from Recent British Experience", paper given at the Cambridge Finance Seminar, 8 Nov 2006, University of Cambridge (paper with author).

<sup>88</sup> Commission Regulation ECNo. 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses, otherwise known as "Prospectus Regulations".

<sup>89</sup> See MIFID Commission Regulation, OJ 2006 L241/1 and MIFID Commission Directive OJ 2006 L241/26.  
<sup>90</sup> At 12.

<sup>91</sup> Articles 4, 5 and 6.

requirements.<sup>92</sup> This may be because many large exchanges such as the Deutsche Börse already impose quarterly reporting on certain listed companies and thus, harmonisation is carried out for the EU at the lowest common denominator instead of the highest common factor. The imposition of requirements in a Member State exceeding the requirements under EU Directives is a phenomenon known as “gold-plating”. As the Transparency Directive adopts a minimum harmonisation approach, which was the old approach in EU securities regulation prior to this round of reforms,<sup>93</sup> mixed signals are being sent to Member States as to the commitment to regulatory convergence. This arguably is a weak link in the regulatory convergence process as, in cybernetic terms, the *norm* of convergence is not even unambiguously *transduced*. An example of an express constraint on gold-plating is found in the MIFID which prevents Member States from imposing more requirements than prescribed under the Directive, with respect to matters covered in the Directive for intermediaries.<sup>94</sup> This provision may also give rise to a query whether, the absence of such a provision in other Directives, such as the Market Abuse Directive, would gold-plating be foreseen or allowed? Although express words to forbid gold-plating in the MIFID may signal towards regulatory convergence, the lack of such express words in other Directives may be construed to undermine regulatory convergence.

### ***Conflict of Regulatory Objectives between National and EU Levels***

As identified in chapter 1, the FSAP goals include economic integration, improving market competitiveness, paying attention to small business needs, investor protection and maintenance of market integrity. The multitude of goals may result in “objective” fragmentation across Member States as each may emphasise on particular objectives appropriate for national interests. For example, the goal of raising regulatory standards for

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<sup>92</sup> Article 4.

<sup>93</sup> Discussed in chapter 1.

<sup>94</sup> Article 31(1), MIFID.

strong markets in the EU may result in the sidelining of small businesses that would find it too costly to raise equity capital in EU markets.<sup>95</sup> Thus, Member States may, in response to small business needs, pursue regulatory divergences to meet domestic needs, such as opting out of the regulated markets regime.<sup>96</sup>

#### *2.4.3 Convergence of Sources of Law under Levels Two and Three?*

The foregoing has discussed the multiversalist effect of Directives, and the fundamental incompatibility between multitudes of norms arising out of the multiversalist effect and norms that need to govern a cybernetic sufficient system. It may however be argued that the critique against Directives is not warranted at this stage as the role of Levels 2 and 3 of the Lamfalussy procedure have to be examined to see if these Levels may somehow cybernetically control the selection of norms for the sources of EU securities regulation.

#### *Level Two Measures*

It may be argued that despite multiversalism and national divergences emanating from the gaps in the substantive law contained in the Directives, Levels Two and Three of the Lamfalussy procedure could exert control over the convergence of national laws and hence the content of the laws.

For example, Regulations could be enacted at Level Two, and these would immediately become binding on Member States without further national transposition, reducing the risk of

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<sup>95</sup> Discussed in H-Y Chiu, "Can UK Small Businesses Obtain Growth Capital in the Public Equity Markets? – An Overview of the Shortcomings in UK and European Securities Regulation and Considerations for Reform" (2004) 28 Delaware Journal of Corporate Law 933. Also see Katherine Krause, "European Union Directives and Poland- A Case Study" (2006) 27 University of Pennsylvania International Economic Law Journal 155, who argues that EU financial regulation Directives do not meet the needs of Poland's financial sector which is highly dependent on debt and less developed in equity markets.

<sup>96</sup> The UK has allowed its second tier market, AIM to opt out of the MIFID.

multiversalism. Examples of Level Two Regulations that leave no further discretion to national regulators are the Prospectus Regulation issued by the Commission regarding the information to be contained in prospectuses;<sup>97</sup> the Commission Regulation issued pursuant to the Market Abuse Directive that deals with exemption for buy-back programmes and price stabilisation measures;<sup>98</sup> and the Commission Regulation issued pursuant to the MIFID governing admission of instruments to trading and price transparency regulation.<sup>99</sup>

However, this thesis suggests that the convergence that could be achieved by Level Two measures is relatively limited.

First, Level One Directives are packed with details,<sup>100</sup> instead of the framework principles earlier recommended under the Lamfalussy Report. This may be partly due to the fact that even at the Parliament level, so many differing views emerge such that many compromises have to be enshrined in the primary Directive, and Parliament may be wary of leaving too much detail to be made at the Commission level. It has also been acknowledged that no general consensus has been reached in defining the level of comprehensiveness or abstractness of Level One measures.<sup>101</sup> Thus, it seems that the approach taken at Level One is to be as detailed as possible and expressly define the scope of what may be filled in at Level Two. Thus, Level Two is limited in scope. Further, many significant issues addressed by Level Two measures have been in Directives,<sup>102</sup> and not in Regulations. Other than the

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<sup>97</sup> Commission Regulation ECNo. 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses.

<sup>98</sup> Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments.

<sup>99</sup> MIFID Commission Regulation.

<sup>100</sup> Moloney, "The Lamfalussy Legislative Model" (2003), op cit at n52, and Burcak Inel, "Assessing the First Two Years of the New Regulatory Framework for Financial Markets in Europe" (2003) 18 JIBLR 363. This is also the view of the IIMG in their third report of November 2004, see n191.

<sup>101</sup> Speech by Arthurs Doctes van Leeuwen, Chairman, Netherlands Authority for Financial Markets, at HM Treasury seminar (London May 2004).

<sup>102</sup> Commission Directive 2003/124/EC implementing Directive 2003/6/EC of the European Parliament and Council as regards the definition and public disclosure of inside information and the definition of market manipulation; Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of

MIFID Commission Regulation that prescribed exactly how price transparency disclosure is to be undertaken, in comprehensive detail, other Regulations seem to be used only for relatively technical and uncontroversial areas such as prospectus information, international accounting standards and well-accepted exemptions from market abuse. This indicates that Level Two is generally not likely to supply convergence where Level One is lacking.

A query that may be raised at this juncture is whether some areas of substantive securities regulation would by their nature, lean towards convergence. Perhaps disclosure standards by their technical nature<sup>103</sup> may be easier to unify than the regulation of intermediary behaviour, which may entail regulators to look at conduct and perhaps intent. However, a brief survey across various legal issues suggests that policy and commercial drivers are more important to convergence than the nature of substantive law. There are movements towards convergence in technical issues such as accounting standards,<sup>104</sup> but there are also movements towards convergence in diverse areas such as human rights,<sup>105</sup> or corporate governance.<sup>106</sup> It seems that drivers such as world trade multilateralism (driving intellectual property convergence)<sup>107</sup>, international policy interest<sup>108</sup> or market demand (driving convergence of standards for securities offerings) are more important in determining convergence.

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the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest; Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices.

<sup>103</sup> It is suggested that standards that are capable of being hermeneutically interpreted on a common platform, could give rise to convergence, such as in accounting standards between the UK and the US, see Lawrence A Cunningham, "Semiotics, Hermeneutics, and Cash: An Essay on the True and Fair View" (2003) 28 North Carolina Journal of International Law and Commercial Regulation 893.

<sup>104</sup> See papers in the *Symposium on the Convergence of Accounting Standards*, (2005) 25 Northwestern Journal of International Law and Business at 509 and 589.

<sup>105</sup> For example, the ECHR.

<sup>106</sup> OECD Principles for Corporate Governance (2004) at <http://www.oecd.org/dataoecd/32/18/31557724.pdf>; Janis Sarra, "Corporate Governance in Global Capital Markets, Canadian and International Developments" (2002) 76 Tulane Law Review 1691.

<sup>107</sup> Under the auspices of the World Intellectual Property Organisation.

<sup>108</sup> International organisations undertake responsibility to set standards or formulate best practices, see J Norton, "An Interim Filling the Gap in Multilateral, Regional, and Domestic Hard Law Deficiencies Respecting Financial Services Integration within the Americas" (2006) 12 Law and Business Review of the Americas 153 at 159.

Next, Level Two measures are specific and constrained and may only supply details where the primary Directive has authorised. For example, Article 13(10) of the MIFID specifies that investment firms have to comply with organisational requirements imposed by the MIFID and Commission legislation may specify the technical requirements of organisational systems or processes investment firms must put in place for uniform application of the provision. The MIFID Commission Directive enacted pursuant to this is thus limited to the mandate in the principal Article, and its provisions deal with organisational matters such as appointing compliance officers and preparing internal audits.<sup>109</sup> The MIFID Commission Directive arguably would not have mandate to deal with matters such as the takeover or acquisition of investment firms, even though that may have an impact on organisation. Where Level One has not specified, Level Two measures would be incapable of filling in a gap. Further, even if the primary Directive has specified supplemental Level Two measures, none may be provided. For example, in Article 26 of the MIFID, MTFs are required to “establish adequate and effective arrangements to facilitate the effective and regular monitoring of transactions undertaken on or through the facility”. The Level Two measure prescribed for this purpose would be the implementing measures that define the arrangements above. However, there are no Level Two measures supplied, which means that “effective arrangements” will be subject to the interpretation of national regulators, who may apply divergent interpretive discretion. The use of Level Two measures is arguably too specific, and is unlikely to be able to exert control over national divergences that can occur under the multiversalism phenomenon allowed in Level One Directives.

Further, Level Two powers are subject to an expiry date or sunset clause. The constraints upon Level Two measures reflect the political realities surrounding the Commission’s delegated law-making power. The delegated powers to the Commission to make Level Two measures have not been received without some wariness. The traditional principal-agent

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<sup>109</sup> Articles 6 and 8.



theory in political science has always warned that delegation of power by principal to agent may produce externalities such as shirking, i.e. that the agent does not do what is required, or does what is beyond the mandate.<sup>110</sup> The Council of Ministers has already voiced its concern about delegation to the Commission, and the Stockholm Resolution<sup>111</sup> prevents the Commission from taking measures that have already been subject to disagreement by the majority of the Council. The Parliament is also wary of the Commission's law-making powers and the Commission has to submit its Level Two measures to the Parliament for in-principle agreement. These constraints upon Level Two measures show that Level Two measures are largely subordinate to Level One Directives, and can hardly be viewed as supplying convergence where Level One fails to do so.

### ***Level Three Measures***

The Level Three role of CESR consists of two aspects, one is providing "control" over the multiversalism process in national transposition so that the multiversal norms could *de facto* become universal norms. The other role of CESR is the information-gathering role in a cybernetically self-sufficient model of regulation. CESR is a common platform for regulators, and it conducts direct information-gathering with industry representatives.<sup>112</sup> Information-gathering is an important function of a cybernetically self-sufficient regulatory model as information provides the insight to future modification of behaviour towards the goal, i.e. convergence. This Part looks at Level Three in both aspects to see if Level Three may provide the "control" needed to achieve regulatory convergence.

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<sup>110</sup> Jeffrey Stacey and Berthold Rittberger, "Dynamics of Formal and Informal Institutional Change in the EU" (2003) 10 JEPP 858.

<sup>111</sup> At n53.

<sup>112</sup> CESR seeks consultation and feedback on any technical measures it may recommend to the Commission, organises *ad hoc* expert groups to study particular issues and also prepares for identification of future problems by setting up a Market Consultants Review Panel. See [www.cesr-eu.org](http://www.cesr-eu.org) (accessed Dec 2005).

In order to provide for “control” over the multiversalism process, CESR uses common standards or guidelines for how regulation may be consistently adopted and applied across Member States. It has been suggested<sup>113</sup> that in order to minimise inconsistencies in national implementation by Member States, there should be *ex ante* controls before national legislation is passed. Such *ex ante* controls involve Commission vetting of national drafts, dialogue and sharing of information between Member States on each other’s national drafts, and even the Commission’s ability to prevent inconsistent national drafts from becoming law. These suggestions, as acknowledged by the commentator himself, may be extremely unpopular. There is no mechanism at the general level of the Community method to “control” subsequent regulatory implementation by Member States. However, CESR’s work seems to approximate towards this, as CESR anticipates likely transposition problems and issues guidelines pre-emptively to deal with them.

CESR anticipates what the problems in national implementation may be, where the interpretation and transposition of the text of the Directives are concerned, and produces standards and guidelines to patch possible regulatory fragmentation. CESR has issued Implementation Standards to aid in the implementation process, and other interpretive standards for further clarification on Level One or Two laws.<sup>114</sup> CESR’s standards or guidelines are drawn up by securities experts in anticipation of interpretive issues that may occur, thus, these guidelines are likely to acquire persuasive authority in Member States, as they present a ready solution to interpretive problems. For example, in the Implementation Guidelines produced for the purpose of implementing the Prospectus Directive and Commission’s Prospectus Regulations, CESR expands on the items of disclosure required under the Commission Regulations, to further identify specific and non-ambiguous items.

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<sup>113</sup> Rodolph Munoz, “The Development of the Ex Ante Control Mechanism” in Takis Tridimas and Paolisa Nebbia (eds), *EU Law for the 21<sup>st</sup> Century (Vol. 2)* (Oxford: Hart 2004) at 103.

<sup>114</sup> CESR’s recommendations for the consistent implementation of the Commission’s Regulation on Prospectuses, No 809/2004, found on CESR website, <http://www.cesr-eu.org>.

Where there may be ambiguity, such as what may constitute the "business plans and prospects" of an issuer, CESR identifies that the disclosure of "risk factors" is necessary. Next, CESR's first standard on Financial Information published on 21 March 2003 deals with the even interpretation and application of the International Financial Reporting Standards by corporate issuers which have to prepare continuous disclosure under the Transparency Directive in accordance with those standards. CESR also organises *ad hoc* expert groups to study particular issues and needs, in order to formulate implementation and interpretive standards. Thus, CESR actively seeks to patch regulatory fragmentation even before it occurs. CESR also prepares for identification of future problems or issues by setting up a Market Consultants Review Panel to advise CESR on its work and areas for review.<sup>115</sup> CESR also works very efficiently and the times between the generation of a consultative document to the making of final CESR recommendations generally take about 3 months. The proactive approach of CESR may greatly facilitate the national implementation process if problems in implementation could be overcome by relying on CESR's recommendations. This would result in practical "control" over convergence although there is no formal institutional structure for such control.

CESR has also established a Review Panel under its auspices to monitor national implementation of the securities Directives and to act as a communication channel for any specific problems faced in the implementation process.<sup>116</sup> Special groups such as the Market Abuse Review Panel and Prospectus Group, and CESR-Pol and CESR-Fin also address the monitoring of convergence in the Market Abuse, Prospectus and MIFID Directives respectively.<sup>117</sup> Although there is no institutional authority in these arrangements as such, the anticipatory approach of being ready to help Member States resolve interpretive issues, and

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<sup>115</sup> See <http://www.cesr-eu.org>.

<sup>116</sup> The importance of the work of the Review Panel as a mechanism to foster convergence is discussed in CESR, 2006 Report on Supervisory Convergence in the field of Securities Markets, 06/259b, June 2006; and the CESR Annual Report 2006, both available on [www.cesr.eu](http://www.cesr.eu). (accessed Oct 2006).

<sup>117</sup> CESR Annual Report 2006, *ibid*.

maintaining communication in the collaborative process, are soft tactics used towards coordination and convergence. Perhaps by taking a proactive approach in anticipating problems, CESR hopes that its ready recommendations may be adopted by Member States and thereby bring about regulatory convergence.

The nature of CESR's role is facilitative, and the adoption of CESR's convergence standards depends on the willingness of Member States. The successful ascertainment of "control" by CESR depends therefore on the practical outworking of CESR's proactive and anticipatory approach, as there is no conceptual or institutional underpinning of CESR's efforts to guarantee the securing of control. As such, in terms of the cybernetic model, the element of "control" is theoretically lacking.

In fact, CESR is conscious that its output may not demand compliance as such, and has therefore placed limitations on its own recommendations. For example, in its Standards on "Accepted Market Practices" in the implementation of the Market Abuse Directive, CESR prescribes criteria for Member States to use in deciding whether to regard a market practice as abusive or not. But Member States ultimately make the decision on whether any market practice is abusive. Thus, it is arguable that even the Standards cannot go far enough to plug regulatory fragmentation.

CESR's standards or guidelines are not command-and-control rules in the traditional understanding of regulation,<sup>118</sup> and they may perhaps best be regarded as "soft law". If CESR's soft law can be regarded as a source of law, then perhaps there is some form of institutional "control" to forge regulatory convergence between the multiversal national laws. If CESR's soft law may be regarded as legal norms in the cybernetic sense of "norm-setting", such norms may be able to consolidate all the multiversalism in national transposition and

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<sup>118</sup> See M Cave and R Baldwin, *Understanding Regulation* (Oxford: Oxford University Press 2003) at ch 2.

direct national laws towards regulatory convergence. If so, then Level Three could bring about a convergence in the sources and content of laws where Levels One and Two may not. However, CESR's soft law suffers from the main problem of the ambiguous status of soft law. The following Part discusses whether CESR's soft law could amount to law in the standard required under the cybernetic model.

#### *2.4.4 Soft Law Produced By CESR*

This Part will discuss the nature of soft law, the rise of soft law in international governance and EU integration, and the rise of theories in governance and legal reasoning that support the status of soft law. This Part will then discuss the potential of such soft law for regulatory convergence in EU securities regulation.

#### *Nature and Importance of Soft Law*

Before attempting to define soft law, it is perhaps more apt to define "hard law" which has been given a more ascertainable definition. Hard law, in the context of understanding what is a legal norm in international law (which is relevant here as the EU regime is neither a purely state-like regime nor a totally international law regime, and Joseph Weiler has consistently preferred to regard the EU as a Treaty-based international order with some facets of constitutionalism rather than a full state-like constitutionalism<sup>119</sup>), means legal obligations which have been fashioned with precision and whose interpretation and adjudication is

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<sup>119</sup> J Weiler, *The Constitution Of Europe-Do The New Clothes Have An Emperor And Other Essays On European Integration* (Cambridge: Cambridge University Press 1999) at chapters 6 and 7, "In defence of the Status Quo-Europe's Constitutional Sonderweg" in J Weiler and Marlene Wind (eds), *European Constitutionalism Beyond the State* (Oxford: Hart 2003) at chapter 1 p7ff. See also J Weiler, "A Constitution for Europe? Some Hard Choices" in J Weiler, Iain Begg and John Peterson (eds), *Integration in an Expanding European Union-Reassessing the Fundamentals* (London: Blackwell 2004) at p17ff.

delegated to a third party, using defined processes.<sup>120</sup> Following from that, obligations or norms that do not totally attain the character of hard law would be characterised as soft law. It could be that these obligations or norms are not defined with sufficient precision, or that interpretation and adjudication are not delegated to a third party, or that such interpretation or adjudication are not carried out under a defined process. It is possible to fall short of any of the 3 requirements of hard law, and such other norms would be generally treated as soft law.

The standards and guidelines of CESR would likely be regarded as “soft law” as most of the guidelines such as Accepted Market Practices, are unlikely to be adjudicated upon, as they do not create binding rights in the first place. However, the regulatory potential of CESR would turn on whether soft law may acquire a *de facto* binding quality or may be a precursor to hard law.<sup>121</sup>

Further, soft law has itself increasingly been recognised as an important source of law. That is because, if soft law is more often than not a precursor to hard law, then the nature of soft law could be regarded as “practically hard”, although formal hardening has not yet taken place.<sup>122</sup> Soft law may be used in contexts and for reasons that do not diminish its nature as being “law”. Abbott and Snidal identify the most important reasons as:<sup>123</sup>

-The avoidance of incurring high transaction costs in the formulation of hard law. At the EU level, it is clear that formulation of law requires an elaborate process as well as consultation with Member States, and therefore, cost in terms of time as well as effort is higher in the formulation of hard law;

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<sup>120</sup> Kenneth W Abbott and Duncan Snidal, “Hard and Soft law in International Governance” (2000) 54 International Organisation 421.

<sup>121</sup> Mario Giovanoli, “Reflections on International Financial Standards as Soft Law” (Essays in International Financial & Economic Law ; No. 37, London : London Institute of International Banking, Finance and Development 2002). Giovanoli is however of the view that soft law is transitory and would eventually harden into hard law.

<sup>122</sup> Christine Chinkin, “The Challenge of Soft law”(1989) 38 ICLQ 850. See also *ibid*.

<sup>123</sup> See n120.

-Allowing the law to develop in a learning process rather than having fixed outcomes which may be costly to deviate from in the future;

-Representing a kind of compromise to move ahead instead of being stuck at an all-or-nothing legal package. This is particularly true in the EU and collaboration in forming soft law to apply to certain circumstances would inherently allow flexibility when circumstances change or when expansion of the EU would need the accommodation of new Member States' interests; and

-Allowing the level of legal obligations to be tailored in accordance with the appropriate regulatory choice. The regulatory methodology for securities regulation may be modified depending on various factors such as competition, efficiency and market demand. Thus, the presence of soft law may facilitate greater ease in such adjustment.

The importance of soft law has grown generally in international governance, and is also viewed as a key tool to European integration in general.

### ***Soft law as a Means of EU Integration and Convergence***

It could be argued that soft law should be regarded as a source of law, particularly in the context of European integration. A commentator pointed out that as the single market began on the platform of a customs union, the elimination of barriers to trade such as tariffs were the main courses of action taken towards integration. This limited form of "integration" accommodated much diversity that was not crucial to the facilitation of trade across borders.<sup>124</sup> With capital mobility and the integration of capital markets, further regulation<sup>125</sup>

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<sup>124</sup> Marise Cremona, "The External Dimension of the Single Market- Building on the Foundations" in C Barnard and J Scott (eds), *The Law of the Single European Market* (Oxford: Hart 2002).

<sup>125</sup> The need for regulation to be present in a global or cross-border financial activity context is argued by Adair Turner, "Global Finance: Engine of Growth or Dangerous Casino?" in *Just Capital* (London: Macmillan 2000) at ch 10. See also early works on international securities regulation in Norman Poser, *International Securities Regulation* (Boston: Little-Brown 1991) and John H Friedland, *The Law and Structure of International Financial Systems: Regulation in the US, EEC and Japan* (London: Quorum Books 1992)

is needed. This is so even if the proportion of capital market activity in traditionally bank-based countries such as Germany, is relatively small.<sup>126</sup> One commentator has criticised the EU in allowing financial regulation integration to seriously lag behind the regimes for movement of goods and persons.<sup>127</sup> Much European integration has been achieved through law,<sup>128</sup> but in recent years, more integration may seem to be controversial, especially when looked at in the context of political realities such as the French and Dutch rejections of the draft EU Constitution<sup>129</sup> and the development of enhanced forms of cooperation between some Member States<sup>130</sup> and not others, or the use of the open method of coordination in lieu of hard law to coordinate policies in some issue areas such as employment.<sup>131</sup> This Part will examine whether there may be any constitutional endorsement of convergence, that could bolster the status of soft law in the area of securities regulation as law, and allow soft law to provide sufficient “control” towards achieving regulatory convergence.

First, it has been argued in some quarters that there is a constitutional order towards European convergence. Advocates of convergence argue that the EU is a supranational polity with a legal system.<sup>132</sup> Although the parameters of its political nature are not yet determinate<sup>133</sup> and

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<sup>126</sup> Geoffrey R.D. Underhill, “Global Capital Markets and EU Financial Integration” (Working Paper No 120 of January 1995) (PAIS Papers, University of Warwick) argues that banks are increasingly engaging in capital markets activities and bearing market risk, and hence, there would be an increasing industry need for regulation.

<sup>127</sup> Steve Peers, “Free Movement of Capital: Learning Lessons or Slipping on Spilt Milk?” in Barnard and Scott (eds), *The Law* (2002), op cit at n117. For a brief discussion on the regimes for movement of goods and persons, see Arnall et al, *Wyatt and Dashwood* (2003), op cit at n28.

<sup>128</sup> Ulrich Haltern, “Integration Through Law” in A Wiener T Diez (eds), *European Integration Theory* (2004), op cit at n46. Thomas M.J. Möllers, “The Role of Law in European Integration” (2000) 48 *American Journal of Comparative Law* 679 discusses law as central to European integration.

<sup>129</sup> June and July 2005.

<sup>130</sup> Introduced in the Treaty of Amsterdam 1998.

<sup>131</sup> Treaty of Nice 2000.

<sup>132</sup> See Matthew J Gabel, “The Endurance of Supranational Governance: A Consociational Interpretation of the European Union” (1998) 30(4) *Comparative Politics* 463 in which the consociational stability of the EU is explained.

<sup>133</sup> Critics generally agree that it is not a federalist polity, but a separate institution with its own competences with both horizontal and vertical relationships with Member States. See Weiler, *The Constitution of Europe* (1999), op cit at n119 and “In defence of the Status Quo-Europe’s Constitutional Sonderweg” in Weiler and Wind (eds), *European Constitutionalism* (2003), op cit at n119, generally, Michael Keating, “Europe’s Changing Political Landscape: Territorial Restructuring and New Forms of Government” in Paul Beaumont, Carole Lyons and Neil Walker (eds), *Convergence and Divergence in European Public Law* (Oxford: Hart 2002) at ch 1.



the nature of the legal system is also subject to controversy,<sup>134</sup> many advocates think that there is a sufficient movement towards general convergence to common standards based on a norm of loyalty,<sup>135</sup> or a principle of constitutional tolerance,<sup>136</sup> or common legal culture,<sup>137</sup> or even varying degrees of constitutionalism, in terms of a near-constitutional order, possibly based on economic freedoms and human rights.<sup>138</sup> Convergence theorists believe in at least a limited constitutionalism based on shared institutions, standards, values and supranational competencies,<sup>139</sup> to a full fledged constitutionalist order akin to a federalist polity.<sup>140</sup>

However, critics who are more skeptical of the convergence movement in the EU have pointed out the realities of fragmentation and diversity, as well as the undesirability of excessive convergence. Most of the arguments for the latter centre around the lack of a demos to support EU constitutionalism,<sup>141</sup> the fundamental incompatibility of legal cultures,<sup>142</sup> and the objectionability of forcing upon the European citizenry a legal order that is elitist, removed from the citizenry and in the interests of lawyers.<sup>143</sup> The non-convergence theorists are also keener to refer to the EU more as an international organisation rather than a

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<sup>134</sup> The idea of a vertical legal system with EU law at the apex is subject to resistance in Member States. On the one hand, the ECJ has pronounced EU legislative supremacy and direct effect of EU laws, but on the other hand, national enforcement of EU law has not been consistent and a German court also recently refused to apply EU law. See Deirdre Curtin and Ige Dekker, "The Constitutional Structure of the European Union: Some reflections on Vertical Unity in Diversity" in Beaumont, Lyons and Walker (eds), *ibid*, at chapter 4.

<sup>135</sup> Curtin and Dekker, *ibid*.

<sup>136</sup> Weiler, "In Defence" (2003), *op cit* at n119.

<sup>137</sup> Carole Lyons, "Perspectives on Convergence within the Theatre of the European Integration" in Beaumont, Lyons and Walker (eds) (2002), *op cit* at n133 at ch 5.

<sup>138</sup> See Ernst Ulrich Petersmann, "The Contradictions of Supranationalism: Administrative Governance and Constitutionalisation in the European Union since the 1950s" (2003) 37 *Loyola of L.A. Law Review* 363 and Grainne de Búrca and Jo Beatrix Aschenbrenner, "The Development of EU Constitutionalism and the Role of the EU Charter of Fundamental Rights" (2003) 9 *Columbia Journal of European Law* 355.

<sup>139</sup> Weiler, "In Defence" (1999), *op cit* at n119.

<sup>140</sup> Koen Lenaerts, "Federalism: Essential Concepts in Evolution-The Case of the EU" (1998) 21 *Fordham International Law Journal* 746, K Lenaerts and Marlies Desomer, "Bricks for a Constitutional Treaty of the EU: Values, Objectives and Means" (2002) 27 *ELR* 377.

<sup>141</sup> Ian Ward, "Amsterdam and the Continuing Search for Community" in D O'Keeffe and P Twomey (eds) *Legal Issues of the Amsterdam Treaty* (Oxford: Hart 1998).

<sup>142</sup> Pierre Legrand, "Public Law, Europeanisation and Convergence: Can Comparatists Contribute?" in Beaumont, Lyons and Walker (eds), *Convergence* (2002), *op cit* at n133 at ch 12.

<sup>143</sup> Carol Harlow, "Voices of Difference in a Plural Community" in Beaumont et al eds (2002), *ibid*, at ch 13. This has however been criticised by Neil Walker as a form of attack against constitutional fundamentalism, which the EU does not represent. See "Culture, Democracy, and the Convergence of Public Law: Some Scepticisms about Scepticism" in Beaumont et al (eds), *Convergence* (2002), *ibid*.

supranational or federal polity.<sup>144</sup> However, the critics against this group of non-convergence theorists explain that although it may be far-fetched to suppose total convergence or near-federalism for the EU, the EU can still be regarded as a constitutional polity that is evolving in terms of coherent processes<sup>145</sup> and institutions.<sup>146</sup> Although it may lack a clearly vertical legal order<sup>147</sup> and faces a potential democratic deficit problem,<sup>148</sup> it should not be too quickly dismissed that a constitutional order is not in place. At the moment, theorists are evenly divided between accepting general convergence as a natural result of integration, and not accepting convergence as reflecting reality.

On a more specific level, could it be argued that there is a limited economic constitution in the EU and therefore, there is a vertically imposed convergence agenda in only the economic laws of the EU? If so, the use of soft law to supplement hard law would be constitutionally consistent and could be more easily accepted as a form of law to secure the convergence of EU securities regulation.

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<sup>144</sup> Ian Ward, "Identity and Difference: The EU and Postmodernism", op cit at n20 which argues that the EU lacks an internal identity either on philosophical or constitutional grounds. Weiler also points out that more internationalist tendencies exist in the EU arrangements than federalist, for example, the amendment of Treaty by unanimity is internationalist and not federalist in nature. See Weiler, "A Constitution for Europe? Some Hard Choices" in Weiler, Begg and Peterson (eds), *Integration* (2004), op cit at n119 at 17ff. Trevor Hartley also thinks that the EU is more an international organisation although some characteristics make it a more tightly controlled polity than other international organizations, such as the compulsory jurisdiction of the ECJ. See *Constitutional Problems of the EU* (Oxford Hart 1999).

<sup>145</sup> Renaud Dehousse, "Beyond Representative Democracy: Constitutionalism in a Polycentric Polity" in Weiler and Wind (eds), *European Constitutionalism* (2003), op cit at n119. Also see Jo Shaw, "Tolerance and Process" in Weiler, Begg and Peterson (eds), *Integration* (2004), op cit at n119.

<sup>146</sup> Johan P Olsen, "Reforming European Institutions of Governance" in Weiler, Begg and Peterson (eds), *Integration* (2004), op cit at n119.

<sup>147</sup> Marlene Wind argues for a more polycentric perspective of EU laws and adopts differentiated integration as a legitimate and plausible form of integration. See "The EU as a Polycentric Entity" in Weiler and Wind (eds) *European Constitutionalism* (2003), op cit at n119.

<sup>148</sup> A number of commentators argue that one should not be carried away by the democratic deficit argument as it is too ethno-centric in nature and also does not reflect fully the fact that a European civic understanding of constitutionalism is possible without the same national system of democracy. See Miguel Poiars Maduro, "The European Constitution: What if this is As Good As it Gets?" in Weiler and Wind (eds) *European Constitutionalism* (2003), op cit at n119. The evolving acceptance of common norms and processes also signify a developing constitutionalism which may not be necessarily restricted to national concepts of demos. See Francis Snyder, "The Unfinished Constitution" in Weiler and Wind (eds), *ibid.*

Some commentators have argued that the economic freedoms laid down in the Treaty of Rome are equivalent to an economic constitution.<sup>149</sup> This is because a “Europeanisation” of economic laws has been relentlessly carried out since the internal market became enshrined as a primary goal.<sup>150</sup> An eminent economist<sup>151</sup> argues that an economic constitution should fulfill six criteria, i.e. the existence of aims and objectives, guiding principles, means of achieving the economic objectives, identification of stages of economic integration, and the existence of public economic functions and powers, exercisable by established institutions. He argues that the Treaty of Rome, taken together with the Single European Act of 1992 and later augmented by the Treaty of Maastricht, forms the economic constitution of the EU. It is also argued that by practising the economic freedoms under the Treaty of Rome, European nationals behave like market citizens, and thus, there is an actual economic *demos* to support the economic constitution.<sup>152</sup> These arguments lend weight to regarding CESR’s soft law, which are for the purposes of regulatory convergence, as a form of viable “control” towards convergence. Another commentator also opined that even if the “economic constitution” is still being defined, the processual nature of the economic constitution is a new form of supranationalism known as “deliberative supranationalism.”<sup>153</sup> Deliberative supranationalism means that there will eventually be an integrated/constitutional structure which evolves out of the dialogic processes between Member States.

However, other commentators have warned against viewing the Treaty freedoms as an economic constitution, as market integration *per se* would not result in a form of European

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<sup>149</sup> Jacques Pelkmans, *European Integration* (Harlow: Pearson 2001) at ch 1.

<sup>150</sup> Manfred Streit and Werner Mussler, “The Economic Constitution of the European Community- From Rome to Maastricht”, in Hans W Micklitz and Stephen Weatherill (eds), *European Economic Law* (Dartmouth: Ashgate 1997) at 30. See also Christian Joerges, “The State Without A Market?” (1996) EUI Working Paper No. 96/2 (EUI, Florence 1996) and “European Economic Law, The Nation State and the Maastricht Treaty” in Micklitz and Weatherill (eds), *ibid*, at 4, where it is argued that although one does not conclude that there is an economic constitution as such, market integration does reduce national competences and sovereignty.

<sup>151</sup> Pelkmans, *European Integration* (2001) at n149 at ch 3.

<sup>152</sup> Michelle Everson, “The Legacy of the Market Citizen” in J Shaw and G More, *New Legal Dynamics of the EU* (1995), *op cit* at n20.

<sup>153</sup> C Joerges, “The Law in the Process of Constitutionalising Europe” (2002) EUI Working Paper 2002/4, (Florence: European University Institute 2002).

constitutionalism without political integration or acceptance of EU constitutionalism.<sup>154</sup>

Besides, as Member States all have the freedom to order their domestic economic policies, it is unreal to assert that there is an economic constitution as such. The freedoms could be regarded merely as policies towards market integration.<sup>155</sup>

Even if we accept that market integration is merely a policy, regulatory convergence may not be of constitutional status, but it could at least be treated as a process and a means to achieving market integration. There are two further possible justifications for the *legal* status of soft law proceeding from CESR. One is that the process-based approaches to EU governance such as flexibility<sup>156</sup>, or differentiated integration, enhanced cooperation<sup>157</sup> and most recently, the establishment of the Open-Method of Coordination (“OMC”) methodologies, which are quasi-legislative in nature, all involve some use of soft law.<sup>158</sup> Thus, soft law is practically expanding its boundaries within EU governance and should be regarded as an expansion of the system of law. The second is that soft law is recognised as a source of law using the theories of inter-legality and legal pluralism.

### ***Soft Law as Law in the EU?***

The traditional approach towards integration has always been a dominant use of legal harmonisation, as endorsed in the White Paper on EU Governance.<sup>159</sup> Legal harmonisation is

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<sup>154</sup> Joseph Weiler, “Transformation of Europe” in Micklitz and Weatherill eds, *European Economic Law* (1997), op cit at n149 at 19.; Damian Chalmers, “The Single Market: From Prima Donna to Journeyman” in Shaw and More (eds), *New Legal Dynamics* (1995), op cit at n20.

<sup>155</sup> Wolf Sauter, “The Economic Constitution of the EU” (1998) 4 *Columbia Journal of European Law* 27.

<sup>156</sup> Treaty of Amsterdam, June 1997. Flexibility is however viewed as a political compromise, see Jo Shaw, “The Treaty of Amsterdam: Challenges of Flexibility and Legitimacy” (1998) 4 *ELJ* 63.

<sup>157</sup> Differentiated integration, variable geometry and enhanced cooperation are all products of the Treaty of Amsterdam, for a comprehensive discussion of implications, see Gráinne de Búrca and Joanne Scott (eds), *Constitutional Changes in the EU: From Uniformity to Flexibility?* (Oxford Hart 2000).

<sup>158</sup> Treaty of Nice, and the OMC is currently used for employment law.

<sup>159</sup> COM 2001/428 final. This is defended by Gráinne de Búrca to be dominant even after the Treaty of Amsterdam, see “Differentiation within the Core? The Case of the Internal Market” in de Búrca and Scott (eds), *Constitutional Changes* (2000), op cit at n157 at 133. She argues that the Internal Market represents an existing

largely carried out using written law enacted at the EU level. There is a gap between “law in books” and “law in action”, and although the legislative process which is heavily underpinned by comitology<sup>160</sup> already incorporates Member States’ input, Member States could still introduce diversities in “law in action.” Thus, soft law may be seen as supplementary to the hard written law, in the post-legislative management of the integration process. It may even be regarded as deriving its mandate from the original legislative instrument.

Soft law is already at work in the EU. Soft law has been undertaken as a supplementary gap filler, in order to achieve an *ex post* coherence after hard law has been formulated.<sup>161</sup> An example of such gap-filling soft law is in the form of Commission Communications.

Commission Communications may be issued to clarify certain specific areas of Directives, and that is a notable type of soft law which approximates to law.<sup>162</sup> Commission Communications may also harden into hard law if applied by the courts. However, the courts have been stringent in their perception of such Communications and have been quick to deny that communications are “law-making” in nature, that they are not supplementary to an established position under the Directives, but rather provide a solution for a new issue.<sup>163</sup> So, the Court’s treatment of the Communication is ultimately rather ambivalent. Although it is not given a formal legal status, its decision-making quality seems to have been endorsed.

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*acquis* that should not be affected by the Amsterdam arrangements and that the dominant mode of accommodating diversity is by permitted temporary derogation.

<sup>160</sup> Michelle Egan and Dieter Wolf, “Regulation and Comitology: The EC Committee System in Regulatory Perspective” (1998) 4 *Columbia Journal of European Law* 499. A detailed discussion of how comitology is practiced and how it largely secures diverse interest representation and consensus in policy development, decision and implementation, is discussed in Mads Andenas and Alexander Türk (eds), *Delegated Legislation and the Role of Committees in the EC* (The Hague: Kluwer Law International 2000).

<sup>161</sup> J Stacey and B Rittberger, “Dynamics” (2003), *op cit* at n109.

<sup>162</sup> Paul Craig, “The Evolution of the Single Market” in Barnard and Scott (eds), *The Law* (2002), *op cit* at n123 at ch 1.

<sup>163</sup> Mads Andenas, “The Financial Market and the Commission as Legislator” (1998) 19 *Company Lawyer* 98.

Soft law in the EU has not been politically or judicially recognised to have an equal status to law, and hence, it is not binding on Member States. The use of soft law is thus theoretically unable to amount to norm-setting in the cybernetic sense, to consolidate the multiversal locations of norm-setting in EU securities regulation. However, soft law can harden and attain a binding effect in future. Thus, it remains an open question to what extent CESR's soft law may become the key to achieving regulatory convergence.

### ***Constitutional Acceptance of Soft Law***

The draft Constitution prescribes that the EU could institute legislative and non-legislative acts. Non-legislative acts include delegated legislation to the Commission but the Constitution is silent on soft law. Paul Craig<sup>164</sup> however thinks that as the Constitution has provided for a hierarchy of norms in the form of legislative and non-legislative acts, this signals the acceptance of non-legislative acts as "norms" too. It may be argued that soft law, which can have practical binding effects, could amount to "non-legislative acts", that should be regarded as a type of norm in the EU. The draft Constitution has however been rejected at the French and Dutch referendums and it is uncertain if it may be ratified after all. However, even if the Constitution accepts non-legislative acts as "norms", an argument still has to be made for CESR's soft law to be regarded as such "norms". This will be dealt with later in Part 2.4.5.

### ***Perspectives from Legal Pluralism and Legalisation***

Soft law is increasingly being viewed as a source of law under the perspectives of inter-legality or legal polycentricity, or commonly known as "legal pluralism".

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<sup>164</sup> Paul P Craig, "The Hierarchy of Norms" in Tridimas and Nebbia (eds), *EU Law (Vol. 1)* (2004), op cit at n112 at 75, 80ff.

Under the theory of legal pluralism, it is posited that law may emanate from various sources, and not just state mandated sources.<sup>165</sup> Santos envisages an interaction or dialogue between different legal sources so that legality is itself a porous legal order, i.e. “the non-determined interpenetration of regulatory mechanisms associated with the state and the popular classes is seen to produce a form of legality that is characterized by an acentric complex of social networks”.<sup>166</sup> The inter-legality proposed by Santos would provide justification for treating CESR’s standards and guidelines as a source of law. Inter-legality tends to accept controversial sources of law such as *lex mercatoria* in private contract law in the EU,<sup>167</sup> as well as commercial law on a global level which appears to be emanating out of decentralised sources.<sup>168</sup>

Legal pluralism has its genesis in primarily non-state sources. These decentralised sources are non-state actors and in the words of Jost Delbruck, “[T]he new international legal order is complemented by the relatively autonomous development of legal regimes by non-state actors, i.e. by lawmaking beyond the state (“law without a state”). Thereby a pluralistic legal order develops that consists of the existing law, the partially transformed international law, and the (relatively) autonomous body of (transnational) law.”<sup>169</sup> Gunther Teubner also argues for a legal pluralism that is based on a variety of indeterminate sources of law, and many centers of influence and decision-making.<sup>170</sup>

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<sup>165</sup> A detailed examination of various forms of legal pluralism can be found in Warwick Tie, *Legal Pluralism: Toward a Multicultural Conception of Law* (Dartmouth: Ashgate 1999).

<sup>166</sup> B Santos, “Law and Community: The Changing Nature of State Power in Late Capitalism”(1982) 8 *International Journal of Sociology of Law* 379. See also Boaventura de Sousa Santos, *Toward a New Common Sense - Law, Science and Politics in the Paradigmatic Transition*, (London: New York University Press. 1995) at 114.

<sup>167</sup> Mel Kenny, “Globalisation, Interlegality and Europeanised Contract Law” (2003) 21 *Pennsylvania State International Law Review* 569.

<sup>168</sup> Klaus Peter-Berger, “The New Law Merchant and the Global Market: A 21<sup>st</sup> Century View of Transnational Commercial Law” (2000) 3 *International Arbitration Law Review* 91.

<sup>169</sup> “Prospects for a World (Internal) Law? Legal Developments in a Changing International System”(2002) 9 *Indiana Journal of Global Studies* 401 at 430.

<sup>170</sup> Gunther Teubner, “Neo-spontanes Recht und duale Sozialverfassungen in der Weltgesellschaft?”, in: Dieter Simon u. Manfred Weiss (Eds.), *Zur Autonomie des Individuums - Liber amicorum für Spiros Simitis*, (Baden-

CESR is not a mandated law-giver in the EU and therefore its codes and principles would be regarded as soft law at best. However, it is not exactly a non-state actor as posited under the legal pluralism theorists either. It has a quasi-public character, as it is set up by the European Commission and is made up of national regulators. Professor Francis Snyder<sup>171</sup> is of the view that quasi-state actors, as well as multilateral and supranational actors should all be able to be regarded as part of this legal pluralism. He is also of the view that the interlinking of economic networks on a global level would entail governance of such linkages by global legal pluralism that consists of a variety of soft laws and best practices.<sup>172</sup>

It has been recognised for some time in the study of international relations that governance of an issue area can be provided by networks of technical departments of various nation states, first espoused by David Mitrany<sup>173</sup> as neofunctionalism.<sup>174</sup> Neofunctionalism predicted that the rise of substate actors such as functional departments carrying out functional regulation, would gradually overtake the making of international law by states. Although pure versions of neofunctionalism are no longer in vogue, it is still acknowledged that a significant amount of delegated policy making to internationally coordinated functional departments has created

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Baden 2000), p. 441, quoted in Klaus Gunther, "Legal Pluralism and the Universal Code of Legality: Globalisation as a Problem of Legal Theory" (2003), accessed through the New York University School of Law website hosting papers as part of the reading program, at <http://www.law.nyu.edu/clppt/program2003/readings/gunther.pdf>. See also Gunther Teubner, "Global Private Regimes: Neo-Spontaneous Law and Dual Constitution of Autonomous Sectors?" in Ladeur, (ed), *Public Governance* (2004), op cit at n12.

<sup>171</sup> Francis Snyder, "Governing Economic Globalisation: Global Legal Pluralism and EU Law", in F Snyder (ed), *Regional and Global Regulation of International Trade* (Oxford: Hart, 2002). See also Peter Muchlinski, "Globalisation and Legal Research" (2003) 37 *International Lawyer* 221 discussing a variety of issues regarding the concept of law in the light of globalisation, and Snyders' view of legal pluralism seemed to be the preferred view of legal pluralism.

<sup>172</sup> F Snyder, "Global Economic Networks and Global Legal Pluralism" EUI Working Paper No. 99/6 (Florence: European University Institute, 1999).

<sup>173</sup> David Mitrany, *The Functional Theory of Politics* (London: Martin Robertson and Co., 1975) at xi-xx. Ernst Haas later expanded this theory and coupled regulatory choices made by the international functional regulators with "public choice" theory in regulation, positing that regulators act for their self interests in cooperating with each other. See *The Uniting of Europe: Political, Social and Economic forces 1950-1957* (Stanford: Stanford University Press, 1968).

<sup>174</sup> Douglas M. Johnston, "Functionalism in the Theory of International Law", (1988) 26 *Canadian Yearbook of International Law* 3. Neofunctionalism is not, however, as important today as it was in the academic literature of international relations of the 1960s. See Richard A. Falk, "New Approaches to the Study of International Law" (1967) 61 *American Journal of International Law* 477.



a form of transnational governance, by “network” action.<sup>175</sup> The growth of such coordinated transnational governance produces legal or quasi-legal norms that are mainly manifested in commercial<sup>176</sup> or financial law.<sup>177</sup>

CESR is a body of intergovernmental representation by the securities regulators of all Member States, and is a network that could be capable of producing governance for EU securities regulation. The governance by transnational functional networks and their creation of soft law is no longer in question nowadays.<sup>178</sup> In fact governance by networks is proposed by an eminent political scientist as the “New World Order”.<sup>179</sup> Under legal pluralism, if one accepts that networks can produce governance, such governance could also be a source of law, then the soft law produced by CESR could arguably be law.

However, there are two major lines of critique against legal pluralism providing the justification for soft law as law. Some commentators suggest that political alliances and compromises are at work in networks and networks are not a truly useful “model” or theory of governance.<sup>180</sup> This is supported by a lack of procedural framework for or conceptual unity in the products of such networks. The network itself is dialogic in nature, and is unable to provide any conceptual framework in which to make policy predictions, or any procedural

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<sup>175</sup> Kal Raustiala, “The Architecture of International Cooperation- Transgovernmental Networks and the Future of International Law” (2002) 43 *Virginia Journal of International Law* 1. See also Sol Piccioto, “Networks in International Economic Integration: Fragmented States and the Dilemmas of Neo-Liberalism” (1996-7) 17 *Northwestern Journal of International Law and Business* 1014.

<sup>176</sup> Anu Piilola, “Assessing Theories of Global Governance: A Case Study of International Anti-trust Regulation” (2003) 39 *Stanford Journal of International Law* 207.

<sup>177</sup> David Zaring, “International Law by Other Means: The Twilight Existence of International Financial Regulatory Organisations” (1998) 33 *Texas International Law Journal* 281 where it is argued that international financial organisations need to be accountable in terms of defined administrative and procedural rules.

<sup>178</sup> Jost Delbrück, “Prospects for a World Internal Law? Legal Developments for a Changing International System” (2002) 9 *Indiana Journal of Global Studies* 401, where it is argued that legal pluralism would allow the recognition of sources of law from non state sources in an international context, including soft law made by transnational functional networks.

<sup>179</sup> Anne-Marie Slaughter, *A New World Order* (New Jersey: Princeton University Press, 2004). See review by Kenneth Anderson whose main critique against networked governance is the erosion of democratic accountability. See “Squaring the Circle? Reconciling Sovereignty and Global Governance through Global Government Networks” (2005) 118 *Harvard LR* 1255.

<sup>180</sup> T König, “Introduction: Modelling Policy Networks” (1998) 10(4) *Journal of Theoretical Politics* 387.

framework to legitimate its soft law.<sup>181</sup> Any decision taken by the network depends on the relations within the network and on how well-coordinated internally the network is.<sup>182</sup> Thus, it would be unsatisfactory to regard the products of such networks as “law”, as traditional concepts of law whether in the Hartian positivist sense<sup>183</sup> or the Fullarian internal morality sense, rest on structures that have greater permanence and transparency than network relations.

Professor Simon Roberts is also wary of the legal pluralism approach and prefers a more certain framework of legality that is associated with the governing order of a state. He is of the view that law is associated with discrete features and institutions including adjudication and enforcement.<sup>184</sup> The danger of representing as law various normative-like orders lies in that no one is able to draw quite clearly the boundaries between law and other normative social orders that are not law.<sup>185</sup> The question of definition has eluded many pluralists. Even though one can accept that there is always plurality in a social science and law is no exception, one should perhaps be less quick in classifying as law, social orders that are not immediately associated with discrete institutions of government-like quality. This argument does come to bear as soft codes promulgated by CESR would likely not be enforceable by the European Court, let alone the national court, which would apply national legislation transposing the Directives. Alternatively, it has been argued<sup>186</sup> that legal pluralism in the EU

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<sup>181</sup> John Peterson, “Policy Networks” in Antje Wiener and Thomas Diez (eds), *European Integration Theory* (2004), op cit at n46 at 126ff.

<sup>182</sup> For coordination problems, some general inter-agency discussion can be found in K. Hanf and F. Scharpf, *Interorganizational Policy Making: Limits to Coordination and Central Control* (London: Sage 1978); R. Gage and M. Mandell (eds), *Strategies for Managing Intergovernmental Policies and Networks* (New York: Praeger 1990).

<sup>183</sup> See generally, H.L.A. Hart, *The Concept of Law* (Oxford: Clarendon Rep 1994), Lon L Fuller, *The Morality of Law* (New Haven: Yale University Press 1964).

<sup>184</sup> “After Government? On Representing Law Without A State” (2005) 68 MLR 1.

<sup>185</sup> William Twining, “Reviving General Jurisprudence” in M Likosy (ed), *Transnational Legal Processes: Globalisation and Power Disparities* (Cambridge: Cambridge University Press 2002) at 4. See also Gunther Teubner, *Global Law Without A State* (Dartmouth: Aldershot 1997) where it is argued that the boundaries between law and other social orders are evolving dependent on the pressures law exerts on society and vice versa.

<sup>186</sup> N.W. Barber, “Legal Pluralism and the European Union” (2006) 12 ELJ 306. But see Marc Amstutz, “In-Between World: *Marleasing* and the Emergence of Interlegality in Legal Reasoning” (2005) 11 ELJ 766 where it is argued that if one accepts that pluralism in sources of law can exist, then the identification of what actually

may give rise to many and conflicting rules of recognition. Thus, one should not be pre-occupied with establishing one rule of recognition for identifying law. However, the commentator himself argues that pluralism in the rules of recognition is to be deplored and offers citizens no certainty in identifying law.

Another theory that may be argued to assist in regarding CESR's soft law as law is the theory of legalisation. The theory of legalisation predicts that on an international level, states would increasingly commit themselves to norms instituted at a multilateral or international level through participation in international organizations.<sup>187</sup>

The theory of legalisation predicts that states would participate in multilateral arrangements that would increasingly commit them to formulate clear and dependable norms which would either become hard or soft law. Legalisation does not imply the adoption of hard law,<sup>188</sup> as a spectrum of legalisation is possible. Thus, soft law promulgated by CESR could be regarded as a type of legalisation, that manifests as well as directs Member States' commitment towards regulatory convergence. Legalisation allows for the recognition of soft law as law as long as the soft law has norm-like qualities that participants can commit to. The 3 features of legalisation are : the extent to which norms are obligatory, the degree of the precision of the norms, and whether interpretation and adjudication is delegated to a third party. The degrees of strengths and weaknesses in each criteria would affect the hardness or softness of the norm in question. Under legalisation, all norms are law, and hardness or softness only reflects certain attributes of the norm and does not affect the intrinsic character of the norm as law.<sup>189</sup>

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amounts to a legal norm can be achieved through time, as these norms can be adopted by social consciousness through an evolutionary process of trial and error and reflexive learning.

<sup>187</sup> See generally, Miles Kahler, "The Causes and Consequences of Legalisation" (2000) 54 International Organisation 661.

<sup>188</sup> Judith Goldstein, Miles Kahler, Robert O'Keohane and Anne-Marie Slaughter, "Introduction to Legalisation and World Politics" (2000) 54 International Organisation 385.

<sup>189</sup> Ibid.

As such, codes and principles formulated by CESR pursuant to Level Three measures in the Lamfalussy framework would find a place in the spectrum of law supported by legalisation. However, legalisation does not deal with the issue of what the consequences may be if a norm is considered “law”. It is a useful theory that describes an international phenomenon but does not prescribe the consequences if sources of law should be expanded. Should CESR’s soft law be regarded as binding on Member States? This would directly affect whether CESR is able to exert control over the convergence process. Should the regulated have an action against Member States that fail to abide by CESR’s standards? Should the standards be reviewable in the European Court? These issues remain unanswered even if one subscribes to the theory of legalisation. Thus, it is unlikely that legalisation would provide a sufficient basis for CESR’s soft law to be regarded as binding law, capable of directing Member States towards convergence in their national transposition.

### ***Drawbacks of Soft Law***

The nature of soft law remains the key obstacle for soft law to be regarded as a source for legal norms in the cybernetic model. Professor Snyder raises the example of *Deufil*<sup>190</sup> to illustrate the limited ability of soft law. In that case, Deufil relied on the Commission’s Communications on State Aids as legal backing for its claim that receipt of some government subsidies was justified. However, it was held in the European Court that such Communications were merely guidelines and did not give rise to any legitimate expectation that those subsidies in question would be exempted from the restrictions against state aids in Articles 92-3 of the EEC Treaty. The Court’s decision thus also implies that Commission Communications lack legal legitimacy and may easily be disregarded as “policy”.

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<sup>190</sup> Case 310/85, *Deufil GmbH & Co KG v Commission* [1987] ECR 90.

The legal basis of soft law has been criticised to be questionable.<sup>191</sup> Besides as soft law is frequently facilitative in nature, but may not endow any rights or obligations, the likelihood of enforceability of these laws is small and probably not in a judicial arena. Soft law does not relate directly to regulatees. It is addressed to national regulators who may or may not implement the soft law. National regulators are not *legally* bound by CESR's norms and national adoption depends on many factors such as peer pressure and the domestic constraints of the national regulator. If these norms are not implemented nationally, it remains yet uncertain how CESR may *enforce* against national regulators. If CESR cannot enforce against the addressees of its soft law, i.e. the regulators, then it is unlikely that CESR's standards and guidelines would be regarded as part of national law, and hence, law. Further, the lack of personal remedies for the regulated, for breaches of these standards, would mean to the regulated or investors, that soft law is not equal to legal norms.

Third, there may be opposition to giving CESR's soft law the status of law, as the standard-promulgating processes of CESR suffer from democratic deficit. Democratic deficit refers to the issue of whether a body can make decisions affecting the citizenry without being elected and therefore not accountable to the public.<sup>192</sup> Delegated legislation to specialist bodies has happened in modern EU governance and thus, not being elected by citizenry may not affect CESR's regulatory role. But most commentators agree that safeguards are needed for such regulatory roles, such as procedural transparency, accountability and participation.<sup>193</sup>

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<sup>191</sup> This is discussed in the IIMG Third Report (Nov 2004), available at [http://ec.europa.eu/internal\\_market/securities/monitoring/index\\_en.htm](http://ec.europa.eu/internal_market/securities/monitoring/index_en.htm). (accessed Feb 2007).

<sup>192</sup> Peter L. Lindseth, "Democratic Legitimacy and the Administrative Character of Supra-nationalism: The Example of the European Community", (1999) 98 Columbia LR 628. "Network regulation" in international law-making is also discussed in Anne-Marie Slaughter, "Governing the Global Economy Through Government Networks", in Michael Byers (ed) *The Role of Law in International Politics: Essays in International Relations and International Law* (Oxford: Oxford University Press 2000) at 177, 181-84 and Robert O. Keohane & Joseph S. Nye, Jr., "Power and Interdependence in the Information Age" (1988) 77 Foreign Affairs 81 at 86.

<sup>193</sup> Damien Geradin and Nicolas Petit, "The Development of Agencies at EU and national Levels" (2004) (Jean Monnet Working Paper 01/04, NYU School of Law 2004).; Giandomenico Majone, *Dilemmas of European Integration* (Oxford: Oxford University Press 2005) at 36ff.

Finally, the legitimization of soft law may have to come from the outcome of achieved integration. Professor Walker has opined, “..the relationship between dynamic and outcome is complex”,<sup>194</sup> and the irony is, one may not give soft law a stronger status until the integration outcome is achieved, but the integration outcome may depend on the strength endowed on such soft law, in order to achieve the integration.

### ***Can Soft Law Act as a Cybernetically Sufficient Control Mechanism Towards Regulatory Convergence?***

It is still controversial that CESR may rely on its standards as being law, to direct Member States towards achieving regulatory convergence. The discussion thus far argues that regulatory convergence in the sources of law in EU securities regulation is unlikely to be achieved in the cybernetically self-sufficient sense, as the use of Directives gives rise to multiversal national laws, which have been shown to diverge. Such divergences may not likely be controlled by Level Two measures. Further, CESR’s soft law at Level Three does not have theoretical or institutional power to control multiversalism towards convergence, as soft law does not have a binding effect and it is controversial to regard soft law as law. Before moving on to look at regulatory convergence in other respects of regulation in chapter 3, this chapter proposes a way by which CESR’s guidelines and standards may be *enforced* in order to act as a viable means of control for regulatory convergence.

#### ***2.4.5 Judicial Enforcement of Regulatory Convergence***

This thesis proposes that it may be possible to achieve regulatory convergence in the current framework, if the European Court is able to judge national transposition using the yardstick

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<sup>194</sup> “Flexibility within a Metaconstitutional Frame” in de Búrca and Scott (eds), *Constitutional Change* (2000), op cit at n157 at 27.

of “convergence” which is higher than the traditional ascertainment of “failure to transpose” provided in Article 226 of the Treaty of Rome.

### ***Legal Enforcement of Convergence***

The yardstick of “convergence” arguably falls within an extended understanding of subsidiarity and proportionality and does not need any treaty amendment to be politically adopted. It will allow the court to apply a higher standard of judgment in assessing the national implementation of the Directives, so that such implementation may be judged for convergence, and not just for the existence of implementation. As CESR is actively overseeing the national implementation process, it may be able to report to the Commission the Member States that are not achieving the “convergent” level of regulation. CESR is increasingly developing the notion of a yardstick of “convergence” in its work under the Review Panel.<sup>195</sup> The Commission may then refer such a Member State to the European Court under Article 226 of the Treaty for non-compliance with EU legislation. The level of non-compliance can be interpreted highly for securities regulation that is subject to regulatory convergence.

The treaty foundational principle of subsidiarity has been increasingly interpreted in a way that favours de-regulation and limitations on EU regulation.<sup>196</sup> The movements of differentiated integration and the open method of coordination are argued to be in line with subsidiarity.<sup>197</sup> However, subsidiarity itself is capable of being interpreted to limit as well as allow EU level action to be taken. Although subsidiarity prefers Member State level action

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<sup>195</sup> 2006 Report on Supervisory Convergence in the field of Securities Markets, available at [www.cesr.eu](http://www.cesr.eu) (accessed Oct 2006).

<sup>196</sup> Treaty of Amsterdam amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts - Protocol annexed to the Treaty of the European Community - Protocol on the application of the principles of subsidiarity and proportionality OJ 1997 C340/10; Gerard Neuman, “Subsidiarity, Harmonisation and their Values: Convergence and Divergence in Europe and the US” (1996) 2 Columbia Journal of European Law 573.

<sup>197</sup> Colin Scott, “The Governance of the EU: The Potential for Multi-Level Control” (2002) 8 ELJ 59.

where that can achieve the same goals, the Protocol to the Amsterdam Treaty provides guidelines for when Community action is necessary such as where there are economies of scale and cross-border effects. Thus, where Community level action can be justified on those guidelines, such Community level actions are just as justified by subsidiarity as deregulation may be so justified on opposite grounds. A similar argument applies for proportionality that, existing literature often interprets proportionality as limiting EU level action to that which is appropriate and necessary,<sup>198</sup> but where EU level action is necessary in order to achieve cross-border regulation and integrative effects, can proportionality not be argued to support the opposite of limited action, i.e. a high level of convergence? Convergence is arguably a yardstick that is justified by subsidiarity as well as proportionality in assessing securities regulation developments in the EU.

However, how will the Court apply the new yardstick of “convergence”? At this juncture, the role of CESR and its soft law become crucial. CESR has produced many guidelines and principles to assist national implementation, as well as supervision and enforcement, so that convergence may be achieved in all regulatory aspects. As CESR’s output is likely to be regarded as soft law at best, it would be difficult to ask the Court to consider CESR’s soft law as a guide to legal assessment of national transposition. This thesis argues that CESR’s soft law could be regarded as law for convergence based on two factors. The first factor relates to the uniqueness of EU governance. The following Part argues that, EU governance is multi-layered and heterarchical in nature, and each layer of governance produces norms to achieve certain governance effects. It is apt to recognise the governance provided by these plural actors and some of the norms that are produced, as law, if such norms conform to a *meta-legal principle of “norm identification”*. The pluralism in EU governance provides the background to discovering legal norms produced by different centers of governance. This

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<sup>198</sup> Phil Sypris, “Legitimising European Governance: Taking Subsidiarity Seriously with the Open Method of Coordination”. EUI Working Paper 2002/10, (Florence: European University Institute, 2002).



thesis does not argue that all the norms produced by any center of governance in the EU should amount to law. This is because, as discussed earlier in the critique to legal pluralism serving as a basis for soft law, legal pluralism cannot by itself provide the conceptual answer to what is an EU legal norm and what is not. There is a need for a conceptual identification of what an EU legal norm is. Thus, the second factor relates to how a *meta-legal principle of norm-identification* or a “rule of recognition”<sup>199</sup> may be fashioned. This thesis suggests that it is possible to fashion a meta-legal principle of norm identification based on the internal morality of law espoused by Professor Lon Fuller.<sup>200</sup> Such a meta-legal principle can be used to justify specifically, CESR’s principles of regulatory convergence as law, and those can then be applied by the Court to assess regulatory convergence in securities regulation, providing a uniting jurisprudence to forge regulatory convergence.

#### ***(a) Plural, Heterarchical and Dynamistic Governance in the EU***

The governance of the EU is a topic that has spawned much writing. On the one end, pure supranational depictions of the EU have long been rejected, as the EU lacks super-state or federal characteristics<sup>201</sup> and its constitutionalism has often been in doubt.<sup>202</sup> On the other end, the EU is more than merely intergovernmentalism<sup>203</sup> as not only Member States drive policy-making, but supra-level EU institutions have a considerable share of policy making powers. EU governance involves many actors at different levels.

The governance of the EU is complex as there are many layers of governance from EU institutions to national governments and institutions, and there is a need to manage pluralism

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<sup>199</sup> Barber, “Legal Pluralism and the European Union” (2006), op cit at n186.

<sup>200</sup> *The Morality of Law* (1976) op cit at n183.

<sup>201</sup> J Weiler, *The Constitution of Europe* (1999) op cit at n119 at chapters 6 and 7. See also J Weiler, “A Constitution for Europe?” in Weiler, Begg and Peterson (eds), *Integration* (2004), op cit at n119 at 17ff.

<sup>202</sup> See Jo Shaw, “Process, Responsibility and Inclusion in EU Constitutionalism” (2003) op cit at n13, and Antje Weiner, “Editorial: The Evolving Norms of Constitutionalism” (2003) 9(1) ELJ 1.

<sup>203</sup> Paul Craig, “The Nature of the Community: Integration, Democracy and Legitimacy” in P Craig and G de Búrca (eds), *The Evolution of EU Law* (Oxford: Oxford University Press 1999).

and diversity. The Treaty of Maastricht which established the Monetary Union and the Eurozone started the process by allowing opt-outs<sup>204</sup> for the UK and a number of Scandinavian countries, and subsequently the Treaty of Amsterdam endorsed the ideas of flexibility and differentiated integration within the EU, that means, the possibility of enhanced cooperation<sup>205</sup> between some Member States excluding others. The Treaty of Nice then endorsed the open-method of coordination of procedural learning and reflexive comparative methodologies in employment law development in the EU.

EU governance in general is increasingly “metaconstitutional”,<sup>206</sup> in that a centralised or hierarchical method of governance similar to state constitutionalism is inappropriate. Plural centers of power, toleration of more uncertain outcomes and an emphasis on procedural and dialogic aspects of governance such as the duty to negotiate and listen, are increasingly taking root in the EU.<sup>207</sup> Soft law is at work in the procedural linkages between multi-levels of governance in the EU. Many commentators largely agree that the EU is characterized by a form of multi-level governance, espoused by Blank, Marks and Hooghe.<sup>208</sup> They argue that EU governance is a multi-level kind where many interactive layers of supranational, state and sub state actors play a part in constituting the governance of an issue area. Cohen and Sabel call the EU a “deliberative polyarchy” which has a central framework in some respects but engages in a deliberative type of learning/decision-making process that is highly negotiative

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<sup>204</sup> See discussion in Wind, “The EU as a Polycentric Entity” in Weiler and Wind (eds) *European Constitutionalism* (2003), op cit at n119.

<sup>205</sup> This is the idea of “enhanced cooperation” between certain Member States that are more ready to do so. However, John Usher has warned against such differentiated integration as Member States may develop different regulatory regimes in groups and there is no opt-in mechanism for the Member States who later wish to be included. Enhanced cooperation may not give rise to future integration. See “Enhanced Cooperation or Flexibility in the Post-Nice Era” in Anthony Arnall and Daniel Wincott (eds), *Accountability and Legitimacy in the EU* (Oxford: Oxford University Press 2002).

<sup>206</sup> Neil Walker, “Flexibility within a Metaconstitutional Frame: Reflections on the Future of Legal Authority in Europe” in de Búrca and Scott eds, *Constitutional Change* (2000), op cit at n156 at 9.

<sup>207</sup> Walker, *ibid*, Jo Shaw, “Constitutionalism and Flexibility in the EU- Developing a Relational Approach” in de Búrca and Scott, *ibid*, at 331, and Olsen, “Reforming” in Weiler, Begg and Peterson (eds) *Integration* (2004), op cit at n119.

<sup>208</sup> Marks, Hooghe and Blank, “European Integration” (1996), op cit at n11.

and intergovernmental in nature.<sup>209</sup> This heterarchical form of governance is without clear hierarchy and there are many and different centers of power, producing constant dialogue, negotiation and renegotiation,<sup>210</sup> and decentered processes of regulation and decision-making.<sup>211</sup> Commentators are however divided as to whether such pluralism in governance would remain or would move towards “deliberative supranationalism” as espoused by Joerges who believes that there would be a centralised form of EU governance in sight.<sup>212</sup> The dispersal of governance is arguably due to the impossibility of EU institutions having all the necessary resources to regulate, displacing national agencies. Increasingly, it is also acknowledged that public institutions are not the only ones in the “regulatory space”,<sup>213</sup> and that the inherent dispersal of resources and competencies allow governance to be undertaken by a multitude of actors. The unique nature of quasi-legislative instruments matches the unique nature of EU governance, and these unique quasi-legislative instruments actually mark out a unique EU regulatory space.<sup>214</sup>

The open-method of coordination (“OMC”) is perhaps even a step further in terms of unique regulatory design, as it allows co-regulation,<sup>215</sup> which is the participation of networks of bureaucracies, organisations and affected actors in the making of norms that would bind themselves. The OMC<sup>216</sup> also sees coordination at the EU level as being fluid and flexible,

<sup>209</sup> “Sovereignty and Solidarity” in Ladeur (ed), *Public Governance* (2004), op cit at n12 at 157.

<sup>210</sup> Shaw, “Process, Responsibility and Inclusion” op cit at n13. Damian Chalmers also emphasises the dialogic aspects of EU governance as being “deliberative” in nature, see “The Reconstitution of European Public Spheres” (2003) 9 ELJ 127.

<sup>211</sup> See generally Julia Black, “Constitutionalising Self-Regulation” (1996) 59 MLR 24, “Decentring Regulation” in (2001) *Current Legal Problems* 103, “Mapping the Contours of Contemporary Financial Services Regulation” (2002) 2 JCLS 253. See also Teubner, “Global Private Regimes: Neo-Spontaneous Law and Dual Constitution of Autonomous Sectors?” in Ladeur, (ed), *Public Governance* (2004), op cit at n12.

<sup>212</sup> See Joerges, “Deliberative Supranationalism” (2002), op cit at n15.

<sup>213</sup> Colin Scott, “Analysing Regulatory Space: Fragmented Resources and Institutional Design” (2001) *Public Law* 329.

<sup>214</sup> Christopher Harding, “The Identity of EU Law: Mapping out the European Legal Space” (2000) 6 ELJ 128.

<sup>215</sup> Anthony Arnall, “What is Governance” (2001) 26 ELR 411.

<sup>216</sup> It may be argued that the Open-Method of Coordination runs counter to the proposed centralisation of legislative authority in the Commission White Paper on Governance, COM (2001) 428 FINAL, *European Governance- A White Paper*. However, there has been much critique against the White Paper’s position on centralisation of legislative authority in the EU. Support for the OMC can be found in J Scott and David M Trubek, “Mind the Gap: Law and New Approaches to Governance in the EU” (2002) 8 ELJ 1. See also Scott, “The Governance of the EU” (2002), op cit at n197. Christian Joerges, who seems to be more in favour of EU

and allows Member States to experiment with “tentative” levels of coordination, based on their perception of how this may affect national interests. The OMC avoids the rigidity of a legislative regime and cession of powers.<sup>217</sup> This increasing pluralism in EU governance undermines the exclusive use of traditional regulation and allows soft law to provide experiments which may temporarily derogate from characteristics of uniformity that is traditionally achieved under hard law.<sup>218</sup> This processual approach tests the boundaries of the cybernetic systems theory as the system itself could be capable of enlarging, collapsing and redefinition. The pluralistic governance in the EU challenges traditional notions of law and regulation. The unique phenomenon of pluralistic EU governance can arguably justify the identification of norms that do not traditionally amount to hard law, as law.

Soft law is at the centre of such a new governance process<sup>219</sup> as its nature is in keeping with the avoidance of rigidity that hard law requires, and its fluid and dynamic nature coheres with the fluid and dynamic governance in the EU. Hence, the instruments of legality that could reflect that fluid and dynamistic nature of EU governance would be different from traditional hard law instruments. Soft law could be regarded as “law” within the context of such a

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supranationalism, also advocates a kind of “deliberative supranationalism” where EU governance is shaped by comitology dialogic influences and exchange of information across the EU. See “Deliberative Supranationalism” (2002), op cit at n15. The OMC may arguably be more consistent with proportionality, see C Scott, above, and Sypris, “Legitimising European Governance” (2002), op cit at n198.

<sup>217</sup> Gráinne de Búrca, “The Constitutional Challenge of New Governance in the EU” (2003) 28 ELR 814 where it is argued that some forms of rigidity may still be desired to prevent the OMC from being too fluid, such as premising the OMC upon a Charter of fundamental rights. The OMC is also arguably an acceptable form of international law based on regime theory. See Jutta Brunnee and Stephen J Toope, “International Law and Constructivism: Elements of an Interactional Theory of International Law” (2000) 39 Columbia Journal of Transnational Law 19.

<sup>218</sup> Eric Philippart and Monika Sie Dhian Ho, “Flexibility and Models of EU Governance” in de Búrca and Scott (eds), *Constitutional Change* (2000), op cit at n157 at 299 argue that pluralistic methods of governance such as enhanced cooperation would ultimately deal better with diversities. Bruno de Witte also argues that pluralistic methods of governance would not necessarily result in disintegration. See ““Old Flexibility”: International Agreements Between Member States of the EU” in de Búrca and Scott (eds), above, at 31.

<sup>219</sup> Sabrina Regent, “The OMC- A New Supranational Form of Governance?” (2003) 9 ELJ 190 advocates that soft law would be in keeping with the OMC to encourage differentiated and gradual regulatory convergence. Some political scientists however view soft law as being more regulatory and supranational than OMC, which is political coordination only. See Susana Borrás and Kerstin Jacobsson, “The Open-Method Coordination and New Governance Patterns in the EU” (2004) 11 JEPP 185.

unique governance process.<sup>220</sup> Professor Francis Snyder is of the view that EU governance would rely heavily on soft law, as institution inertia, political disagreement and administrative inefficiency would often prevent hard law integration from being achieved. Soft law is also seen as consultative and flexible and therefore caters for the dominantly intergovernmental nature of EU discussions.<sup>221</sup>

In fact, postmodernists such as Ian Ward have argued that the indeterminate but plural nature of EU governance is necessary as it reflects the inherent diversity of the EU. An aspiration towards something simply more supranational and overarchingly “Europe” is in fact impossible<sup>222</sup> and may deny the very nature of “Europe” itself.<sup>223</sup> Thus, it would be normal for the EU to be subject to continuously negotiated governance between pluralistic and diverse centers of governance.

Diverse centers of governance produce different influential effects on the issue area under governance in their own ways. Since influential effects are produced by these centers, some norms that are produced by these centers of governance may have practically binding effects as strong as law. The theory of legal pluralism discussed above may also be used as a starting point to justify the view that norms produced by diverse centers of governance could be regarded as law, as these norms may achieve practically influential effects no different from law. However, legal pluralism raises important queries on the nature of law, in particular that no rule of recognition is provided to recognise what may be law, as distinct from other social orders. This thesis suggests an alternative view, that is, to recognise as law, the norms

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<sup>220</sup> David M Trubek and Louise G Trubek, “Hard and Soft Law in the Construction of Social Europe: The Role of the Open Method of Coordination” (2005) 11 ELJ 343 where it is argued that soft law would have a large part to play in OMC and would encourage quality standards and guidelines to be fostered. These could be as binding as hard law.

<sup>221</sup> Francis Snyder, “Soft Law and the Institutional Practice in the European Community” (1993) EUI Working Paper No. 93/5 (EUI, Florence, 1993).

<sup>222</sup> See Ian Ward, “The End of Sovereignty and the New Humanism” (2003) 55 Stanford Law Review 2091.

<sup>223</sup> Jacques Derrida, *The Other Heading: Reflections in Today's Europe* (translated by Pascale-Anne Brault and Michael B Naas) (Bloomington: Indiana University Press 1992).

produced by these diverse centers, using a rule of recognition based on the *nature of legal norms*. Only if the norms satisfy the criteria laid down in the rule of recognition for identification of legal norms, would the norms be regarded as law. If this rule of recognition is adopted, then the convergence standards and guidelines of CESR can be regarded as law, and can be used as a yardstick for assessing “regulatory convergence” in the European Court.

However, it could be argued that, if the basis that is to give soft law the status of law, is that of the general plural and dynamistic governance in the EU, this basis does not help CESR to elevate soft law to a cybernetically sufficient “controlling” mechanism for regulatory convergence. This is because soft law is used in these contexts of plural and dynamistic governance to accommodate divergences and to engage in dialogue. The fundamental objectives served by pluralism in EU governance are arguably different from regulatory convergence. Therefore, although it may be argued that the nature of EU governance may give rise to greater latitude for determining what law is, the context of fluid and dynamistic governance arguably does not do much for bolstering the status of soft law in the cybernetic model. Such “soft law” may, contrary to the goals of regulatory convergence, be justified as further platforms for negotiated governance and temporary divergences.

However, this thesis argues that the nature of governance itself still cannot suffice to define what law is. Thus, using the pluralism in EU governance to bolster the status of soft law is not misconceived nor does it detract from regulatory convergence. In fact, acknowledging pluralism allows one to acknowledge the interacting role of the Commission, CESR and national regulators as plural actors within the securities regulatory space, and cybernetic systems accommodate the actions of plural actors so long as such actions are coordinated in a cybernetically sufficient way. Such coordination can be achieved towards regulatory convergence if CESR’s soft law in regulatory convergence may amount to norms for the system. In order to recognise CESR’s soft law as law, there is still a need for a conceptual

identification of what law is. This returns to the autopoietic theory of law, that law is a self-referential system that is not dependent on changes in perspectives in other systems such as political science or sociology.<sup>224</sup> Although autopoiesis has been criticised in that boundaries between schools of disciplines are not as clear as one imagines and are actually porous,<sup>225</sup> allowing some influence of systems upon each other, there is danger in taking the totally opposite view that all boundaries are porous, as changes in the law would then be legitimately effected by changes in political authority or caprice.<sup>226</sup> Thus, this thesis supports a semi-strong version of autopoiesis in law, and argues that although EU governance may be moving into a fluid and processual stage, it is not appropriate to equate such governance with regulation and to identify all the norms of such governance as law.

In sum, although the fluid and dynamistic governance in the EU may apparently weaken the movement towards regulatory convergence in a cybernetic model of analysis, the nature of the governance itself is only used as a context to observe where law may emanate. There is still a need to fashion a *meta-legal principle of norm-identification* or a rule of recognition for such norms. Such a principle may then justify CESR's soft law as law and may bolster such soft law to the status of being a viable form of "control" for regulatory convergence. The next Part deals with the *meta-legal principle of norm-identification*.

### ***(b) Identification of an EU Regulatory Norm***

This thesis has argued that it is necessary to look to a *meta-legal principle* that is a rule of recognition, providing the bedrock for defining what an EU legal norm is. Such *meta*

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<sup>224</sup> Teubner, "After Legal Instrumentalism" in Teubner, *Dilemmas of Law* (1986), op cit at n9; Teubner (ed), *Autopoietic Law* (1988), a useful synopsis is found in Jacobson, "Autopoietic Law: The New Science of Niklas Luhmann" (1989), op cit at n9.

<sup>225</sup> Baxter, "Autopoiesis and the Relative Autonomy of Law" (1998) op cit at n9.

<sup>226</sup> Neil MacCormick, "Institutional Normative Order: A Conception of Law" (1997) 82 Cornell Law Rev 1051 explains the necessity for distinguishing law from other orders.

institution may also be necessary in the autopoeitic<sup>227</sup> sense in that the identification of the norms *per se* should not be directly dependent on what may be accepted as governance at any one point in time, and that the norms should have an internal system of significance and constancy. Jurisprudence is the study of such a *meta-legal principle*, and jurists have defined as law, *inter alia*, government or power-backed law,<sup>228</sup> law based on rights,<sup>229</sup> morality,<sup>230</sup> justice,<sup>231</sup> or a pure but elusive *grundnorm*.<sup>232</sup> Where the EU is concerned, the dominant discussion in the legitimacy of the EU lies in the procedural aspects of its structures and linkages,<sup>233</sup> and hence, a *meta-legal principle of norm identification* for the EU may be based on a procedural framework to determine the essential features of what could be identified as an EU legal norm.

Such a procedural framework is based on Professor Fuller's work on how law may be identified.<sup>234</sup> This framework, in the Fullerian sense, is more than mere procedure. It may encompass issues such as how laws are notified and whether retroactivity is allowed, an almost constitutional-cum-procedural list of features which serve in the identification of law. Fuller himself provides eight features in a list for his internal morality of law, i.e. the quality of generality of application, the fact of promulgation, rules dealing with the prohibition against retroactivity of laws, sufficient clarity, avoidance of contradictions, not requiring the impossible, sufficient constancy of the law through time and congruence between official action and declared rule.<sup>235</sup> Fuller's list is the starting point for the fashioning of a meta-legal principle for the identification of legal norms in the diverse governance output in the EU. If

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<sup>227</sup> See n224.

<sup>228</sup> In the Austinian or Hartian sense, see Hart, *The Concept of Law* (1994), op cit at n2.

<sup>229</sup> R Dworkin, *Taking Rights Seriously* (Harvard University Press 1977, Rep 2005).

<sup>230</sup> See Hugo Grotius' theories, generally discussed in Knud Haakonssen, *Natural Law and Moral Philosophy: From Grotius to the Scottish Enlightenment* (Cambridge: Cambridge University Press 1996). See also John Finnis, *Natural Law and Natural Rights* (Oxford: Clarendon 1980).

<sup>231</sup> John Rawls, *A Theory of Justice* (1971, Belknap Press Rep 2005).

<sup>232</sup> Hans Kelsen, *A Pure Theory of Law* (Transl by Max Knight) (1934, California: Berkeley University Press Rep 2002).

<sup>233</sup> Shaw, "Process, Responsibility and Inclusion" (2003), op cit at n13; Olsen, "Reforming European Institutions of Governance" in Weiler, Begg and Peterson (eds), *Integration* (2004), op cit at n119.

<sup>234</sup> See Lon L Fuller, *The Morality of Law* (New Haven: Yale University Press 1964).

<sup>235</sup> *Ibid* at ch 2.



the EU arrives at a list of procedural principles in the identification of “EU legal or regulatory norms” which apply in every issue area, and to every governance center, this list would not only identify important norms that have the effect of law in an issue area, but could become a procedural institution akin to a unique EU “rule of law”, and could serve as a way to reinforce social acceptance and legitimacy for the complex EU governance.

This thesis applies the features in the procedural list to help identify what may be an EU legal norm. First, the source of the norm should be an accepted center of power, e.g. a Member State, a Member State’s regulator, a recognised network that has achieved stability, or an EU administrative agency. The accepted centers of power should be a list of locations that are drawn up and agreed on at the political level. As CESR has been tasked by the Commission to oversee convergence, CESR should also be an accepted center of norm production. Next, the nature of the norm should be generally applicable to all Member States, and thus, specific and individual measures may be excluded from legal identification. The norm should be effectively publicised, and hence, internal guidelines or procedures should be excluded from legal identification, although in this age of website publishing, many things are equally available to the public. However, it may be possible to adopt a special procedure of publication that distinguishes certain norms from others. CESR’s Himalaya Report of 25 Oct 2004<sup>236</sup> that sets out its agenda for regulatory convergence and its measures for regulatory convergence is self-contained and well-distinguished from other reports. Thus, the convergence principles contained in the Himalaya Report provide the context for specific measures of convergence made pursuant to the Report.

CESR’s guidelines for regulatory convergence are defined in the Himalaya Report of 25 Oct 2004 (which sets out the agenda of regulatory convergence and the mechanisms of convergence). Thus, there is sufficient clarity as to which of CESR’s output are made

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<sup>236</sup> Op cit at [www.cesr.eu](http://www.cesr.eu) (accessed Oct 2006).

pursuant to those guidelines. It is submitted that those guidelines which are made pursuant to regulatory convergence as defined in the Report, should be regarded as having a legal nature. For example, CESR Standard No. 1 on Financial Information<sup>237</sup> dealing with the use of international accounting standards based on the antecedent EU Regulation could be regarded as capable of amounting to interpretive norms.<sup>238</sup> Other standards include Standards for Securities Clearing and Settlement in the EU which deals with issues such as linkages between trade and settlement systems, settlement cycles and operating times and safe structures for securities lending and borrowing.<sup>239</sup> Another problem identified by CESR<sup>240</sup> in relation to the Prospectus Directive is that large issuers may wish to make multi-product offerings on one prospectus, or multi-issuer offerings (offerings made by different parts of the same group) on one base prospectus. The Directive's assumptions again are insufficient to accommodate such offerings as it assumes one issuer, one product and one prospectus throughout the provisions. CESR recommended the accommodation of such multi-product or multi-issuer situations by accepting one base prospectus.<sup>241</sup> In relation to continuous disclosure of information by issuers, CESR also recommends standards on how alternative performance measures may be used in addition to financial reporting.<sup>242</sup> CESR's recommendations or 10 guidelines on market data reporting also have the quality of norm-setting.<sup>243</sup> These standards have the features of sufficient clarity and constancy in order to be recognised as norms. This thesis also suggests that these norms are arguably justiciable, i.e. capable of judicial interpretation, by the European Court. The criterion of justiciability will

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<sup>237</sup> of 1 March 2003, available on <http://www.cesr-eu.org/index.php?docid=192>.

<sup>238</sup> Regulation (EC) No 1725/2003 adopting certain international accounting standards in accordance with Regulation (EC) No. 1606/2002.

<sup>239</sup> Of 22 Oct 2004, available at <http://www.cesr-eu.org/index.php?docid=2534>.

<sup>240</sup> The Committee of European Securities Regulators was formed after the recommendations in the Lamfalussy report and originally was a voluntary network of regulators known as FESCO. More on the role and work of the Committee will be explored in the following chapters. See CESR Recommendation no 809/2004.

<sup>241</sup> CESR Implementation Guidelines no 809/2004 (10 Feb 2005), available at <http://www.cesr-eu.org/index.php?docid=2999>.

<sup>242</sup> CESR Recommendation on Alternative Performance Measures (3 Nov 2004), available at <http://www.cesr-eu.org/index.php?docid=3601>.

<sup>243</sup> CESR, *Publication and Consolidation of MIFID Transparency Data* (Feb 2007), available at [http://www.cesr-eu.org/index.php?page=document\\_details&from\\_title=Documents&id=4228](http://www.cesr-eu.org/index.php?page=document_details&from_title=Documents&id=4228).

filter out those norms that are vague principles and in an experimental stage, therefore not amounting to a legal norm.

It is submitted that CESR's guidelines and standards of convergence are sufficiently general, publicised and constant enough to be regarded as amounting to law, and can be utilised by the European Court to assess whether national laws have "converged". The European Court, based on the Fullerian principles of norm recognition, can interpret CESR's principles of convergence to judge the level of Member State transposition, and produce jurisprudence that forges such convergence.

Without the existence of an express EU agency for securities regulation, it is possible for the Court to bring about the necessary jurisprudence for convergence if a meta-legal principle of norm identification is accepted to recognise CESR's standards of convergence as having a legal nature. This model may arguably provide a precedent for high-level integration in other areas of EU governance.

### **3. The Limits to Regulatory Convergence?**

Finally, there is a school of thought in the social sciences that where global regulation is concerned, rules of law in a technical and specific sense cannot be appropriate for that scale of regulation. Rather, rules of principles<sup>244</sup> featuring broader values suffice for what may be considered "global regulation". Such broader values include transparency and reciprocity. Regulation on a global scale is thus moving towards forging best practices, common standards or codes that are based on principles, rather than rigid codes of law. Applying this perspective to look at securities regulation on an EU level, it may be argued that regulatory

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<sup>244</sup> John Braithwaite and Peter Drahos, *Global Business Regulation* (Cambridge: Cambridge University Press, 2000) at 507.

convergence can only be achieved in a broad sense and it is inappropriate for CESR's guidelines to achieve a form of control that forces Member States to be uniform.

However, in applying the cybernetic model to examine regulatory convergence, the inquiry in this thesis is precisely whether or not the convergence of substantive law is possible. The discussion in the following chapter will hopefully shed some light on whether the suggested limits in the preceding paragraph are true.

#### **4. Conclusion**

Regulatory convergence in the sources of laws is important as divergence in sources often results in divergence in content, as seen in the multiversalism phenomenon. Regulatory convergence in sources would have been possible under the Lamfalussy recommendations if Regulations were adopted to govern securities regulation in the EU. However, with the use of Directives, multiversalism persists and is unlikely to be counteracted sufficiently by Level Two measures or CESR's soft law. As of the present, CESR's soft law does not amount to the "norm-setting" function in a cybernetically self-sufficient system of regulation, to direct Member States towards regulatory convergence in the sources of law.

The next chapter will discuss the aspects of law in action in the process of regulatory convergence. A cybernetic model of analysis will be used to examine if regulatory convergence in interpretation, administration, supervision and enforcement may be achieved in spite of the divergence in sources of law.

## **Chapter 3**

### **Regulatory Convergence in Law in Action**

#### **1. Introduction**

In the last chapter, this thesis examined the issue of regulatory convergence in the sources of law for EU securities regulation. Using a cybernetic model of analysis, it is argued that where the sources of securities regulation are concerned, regulatory convergence falls short of being forged on a cybernetically sufficient level. However, regulatory convergence consists of aspects of law in action as well, i.e. 1) interpretation and administration of the laws, 2) supervision of compliance with the laws; and 3) enforcement of the laws. It may be argued that in spite of the lack of convergence in the sources of law, the practice of EU securities regulation could be made to converge. This seems to be CESR's vision as its emphasis is on supervisory convergence in order to achieve regulatory convergence.<sup>1</sup> In this chapter, this thesis will look at all 3 aspects of law in action and using the cybernetic model of analysis, discuss whether regulatory convergence could be secured in any of these aspects.

#### **2. Regulatory Convergence in Interpretation and Administration of Securities Laws**

The interpretation and administration of securities laws refers to how national regulators apply the relevant Regulations and nationally transposed Directives. As discussed in Part 2.4.2 in chapter 2, the substantive laws in the Directives have left many areas for the discretionary application by national regulators. However, as discussed in Part 2.4.3 in chapter 2, CESR tries to issue implementation guidelines and standards in order to guide

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<sup>1</sup> See in particular, para 4.4, CESR, *Revised Charter for the Committee of European Securities Regulators* (2 Aug 2006) at [www.cesr-eu.org](http://www.cesr-eu.org).

regulators in their application of discretion, so that regulators would apply their interpretation in as convergent a manner as possible.

Using a cybernetic model of analysis, CESR's standards and guidelines could be the norms that guide regulators' discretionary interpretation of the laws. These norms are, as discussed in Part 2.4.4 of chapter 2, soft law, and arguably not legally binding upon national regulators. Unless there is judicial enforcement of CESR's guidelines as discussed in Part 2.4.5 of chapter 2, strictly speaking, CESR's guidelines and standards may not amount to norms for interpretation in the cybernetic model of analysis. However, there are a few factors that may provide *de facto* binding quality for these norms. First, some of these norms deal specifically with guiding regulators' discretion in the interpretation of sometimes technical laws, and in the absence of other competing factors, regulators may apply these norms. Second, the network influence of CESR provides peer pressure for regulators, and may persuade regulators to adopt the norms as *de facto* binding.

Where the guidelines for interpretation issued by CESR deal with technical aspects of interpretation of laws, the technicality of those guidelines may be critically important to their practical convergence effect. An eminent commentator has written extensively on how technical or functional aspects of regulation in the EU may become centralised in EU agencies because of the technical nature of the regulation, not bearing on issues of distribution and justice which are more politically sensitive and less likely to become centralised.<sup>2</sup> The technical nature of securities regulation may also lead national regulators to adopt the convergent interpretive practices recommended by CESR. These may not be overly resisted by political forces in the domestic sphere since they deal with technical aspects of regulation. For example, CESR's Standard No. 1 on Financial Information Enforcement has

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<sup>2</sup> See G. Majone, *Regulating Europe* (London: Routledge 1996).

been implemented in most Member States except a few.<sup>3</sup> In terms of prospectus information, much consensus has also been forged among CESR members on interpreting various requirements in the Directive and Commission Regulation on prospectuses. The agreed positions are published in a CESR Frequently-Asked-Questions document available on its website.<sup>4</sup>

However, not all CESR's recommendations are able to forge interpretive convergence. For example, national regulators are concerned about the interpretation of what may amount to "market abuse" under the Market Abuse Directive. Member States are keen to ascertain what practices may be deemed as "acceptable market practices" so that industry participants may be clear as to when liability may be attracted. The Commission Directive on accepted market practices<sup>5</sup> provides for the procedural steps that Member States ought to take in allowing certain practices to be accepted market practices, such as consultation with other industry participants, the factors that are relevant to Member States' consideration, and appropriate disclosure for the rationale of instituting any accepted market practice. CESR has further consolidated these requirements into a standard form for national regulators to fill in with respect to justifying the classification of any market practice as "accepted". The standard form provides for regulators to assess their decision against overriding principles of investor protection, such as levels of market transparency and effects on the flow of supply and demand for investment instruments. The form also facilitates Member States in making rational considerations based on factors listed in the Commission Directive, on whether to accept a practice as an "accepted market practice", but do not prescribe what these accepted market practices should be. Thus, Member States forge their accepted market practices individually and although they notify CESR when decisions concerning market practices

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<sup>3</sup> Documented by CESR's Review Panel, at <http://www.cesr-eu.org/index.php?page=rp&mac=0&id=> (accessed Feb 2007).

<sup>4</sup> *Frequently Asked Questions Regarding Prospectuses: Common Positions Agreed by CESR Members* (updated Feb 2007), at <http://www.cesr-eu.org/index.php?page=groups&mac=0&id=40> (accessed Feb 2007).

<sup>5</sup> Commission directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices.

have been made and all notified practices are centrally found on CESR's website, there is no evidence of an EU-wide consolidation of what may be considered as accepted market practices.<sup>6</sup> Further, CESR's recommendation on market data reporting<sup>7</sup> seeks to streamline reporting formats and access to information without being overly prescriptive. Thus, CESR recommends that new entrants to reporting should adopt existing protocols and not develop new proprietary ones.<sup>8</sup> However, existing suppliers of market data, namely the large exchanges such as London Stock Exchange, Euronext and the Deutsche Börse all have dedicated protocols and feeds for dissemination their information,<sup>9</sup> and CESR's recommendations, which refer to prospective providers, are not likely to affect the diversity in the market which may persist for some time. Moreover, it is uncertain if the recommendation is addressed to regulators or markets. Where the former is concerned, the regulator may not see it necessary to regulate the commercial format of information delivery, as this may unduly stifle innovation. Where the latter is concerned, CESR's recommendations may be easily ignored as there is no direct binding effect.

The network influence of CESR may however be an important factor in securing *de facto* convergence in interpretive practices. An analogical model from international law may be used to describe the network arrangement of CESR. CESR may be akin to an "international regime". An international regime is an arrangement where international representatives are in a cooperative relationship vis a vis each other, in a "regime" consisting of soft understandings, and decisions made in that regime would usually require unanimity. Such "regimes" may not be institutions, and have largely evolved from the need to cooperate with each other on

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<sup>6</sup> See <http://www.cesr-eu.org/index.php?page=groups&mac=0&id=51>, accessed April 2006.

<sup>7</sup> CESR, *Publication and Consolidation of MIFID Transparency Data* (Feb 2007), available at [http://www.cesr-eu.org/index.php?page=document\\_details&from\\_title=Documents&id=4228](http://www.cesr-eu.org/index.php?page=document_details&from_title=Documents&id=4228).

<sup>8</sup> Para 5.4, *ibid*.

<sup>9</sup> More details in I Chiu, "Delegated Regulatory Administration in EU Securities Regulation" (2007) *International Lawyer* (forthcoming).



technical and functional issues, such as the early EC Coal and Steel agreements.<sup>10</sup> Regime theory is premised upon the assumption that cooperation begets cooperation and a cooperative environment produces more constructive results towards a common desired resolution.<sup>11</sup>

Regimes have some form of organisational behaviour, and with time, a collection of precedent decisions on how to deal with similar issues may be built up, and processes of decision-making may become more refined and may achieve the status of “bindingness” in the normative behaviour of regime components. Regimes may also build close and cohesive relationships between the technocrats involved in the regime. These factors may arguably produce a closer regime that would dynamically move towards some form of institutionalisation.<sup>12</sup> CESR has progressed as a rather cohesive body, and has endeavoured to cement its identity by institutionalising a Himalaya Report<sup>13</sup> of its role and functions and a Revised Charter.<sup>14</sup> It is suggested by an eminent international relations commentator that decision-making and effects from networks and regimes may be crucial to the future of international governance in many issue areas,<sup>15</sup> and thus, the power of the regime of CESR may allow its guidelines to acquire *de facto* authority with Member States.

However, regimes depend heavily on mutual cooperation, and experience in international agreements shows that regimes based on unanimity and cooperation often experience

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<sup>10</sup> Thomas Gehring, “Integrating Integration Theory: Neofunctionalism and International Regimes” European University Institute Working Paper 95/39 (Florence: EUI 1997). However, there is some disagreement on this. Some international relations scholars have commented that in the order of increasingly broad concepts of governance, institutions, followed by regimes, then governance itself is the order, and regimes are a subset of governance, and can themselves be referred to as “institutions” in the sense of having a defined set of norms and rules followed by participants, in a particular issue area, although not necessarily having a formal organisational outfit. See Stephen D Krasner (ed), *International Regimes* (Ithaca: Cornell University Press 1983) at 2. Robert Keohane refers to all regimes as institutions in that sense, see *After Hegemony: Cooperation and Discord in the World Political Economy* (New Jersey: Princeton University Press 1984).

<sup>11</sup> Alexander Wendt, “Constructing International Politics” (1995) 20 *International Security* 71.

<sup>12</sup> Gehring, “Integrating Integration Theory” (1997), op cit at n10.

<sup>13</sup> 25 Oct 2004, available at [www.cesr-eu.org](http://www.cesr-eu.org) (accessed May 2005).

<sup>14</sup> 2 Aug 2006, available at [www.cesr-eu.org](http://www.cesr-eu.org) (accessed Nov 2006).

<sup>15</sup> Anne-Marie Slaughter, *A New World Order* (New Jersey: Princeton University Press 2004).

preference change in Member States' behaviour as self-interests are pursued. Preference change makes a regime arrangement volatile, and could also be due to more fundamental and permanent changes in the behaviour of regime participants or changes in ideology.<sup>16</sup> This is an inherent weakness in "regime type cooperation" as regimes are highly based on consensus,<sup>17</sup> and perhaps only a high degree of institutionalisation may be able to curb flagrant deviations from participants.<sup>18</sup> Some hard law and enforceability may give more of an institutional structure to regimes.<sup>19</sup> Without hard law and enforceability, regime influences alone may not produce certain convergent results. This is highlighted in another example below.

One of the problems in regulatory convergence in the administration and interpretation of securities laws is that, many Member States already have an existing infrastructure for interpretation and administration, and path dependence may mean that national regulators may not wish to deviate significantly from what they have been used to. For example, in the definition of "inside information", the UK and Germany have enacted similar definitions based on the Market Abuse Directive.<sup>20</sup> There is however a slight potential for interpretive divergence which could amount to significant divergence in the future. In the UK's FSA Handbook, inside information is defined by reference to its likely effect on the price of the

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<sup>16</sup> C Mantzavinos, *Individuals, Institutions and Markets* (Cambridge: Cambridge University Press 2001). Ideological changes are discussed in D North, *Structure and Change in Economic History* (Cambridge: Cambridge University Press 1981).

<sup>17</sup> Mark W Zacher and Brent A Simon, *Governing Global Networks* (Cambridge: Cambridge University Press 1996) at 13-35 for a general discussion of regime theory. Consensus may also be argued to be explicit or implicit, see R Keohane, "Analysis of International Regimes" in B Rittberger (ed), *Regime Theory and International Relations* (Oxford: Clarendon 1993) at 23, and Frederick V Kratochwil et al, "International Organisations: A State of the Art or An Art of the State" (1986) 40 *International Organisation* 753.

<sup>18</sup> This is the underlying theory of the neo-liberalists who believe that institutions by providing rules, norms and frameworks for behaviour and dispute settlement, are able to constrain otherwise anarchic behaviour on the part of states. See a succinct and well-discussed summary of various theories of state behaviour, the realist and neo-realist schools, the liberal and neo-liberal schools and the functionalist and neo-functionalist schools, in Linda Cornett and James A Caparaso, "And Still It Moves! State Interests and Social Forces in the European Community" in J Rosenau (ed), *Governance Without Government* (Cambridge: Cambridge University Press 1992, rep 2000) at 219.

<sup>19</sup> George W. Downs, Kyle W Danish and Peter N Barsboom, "The Transformational Model of International Regime Design: Triumph of Hope or Experience" (2000) 38 *Columbia Journal of Transnational Law* 465.

<sup>20</sup> See FSA Handbook on Market Conduct, Glossary, for the definition of "inside information", see section 13, Securities Trading Act (Gesetz über den Wertpapierhandel/ Wertpapierhandelsgesetz – WpHG) for the German definition.

relevant market instruments. In the German Securities Trading Act which was enacted following the Insider Dealing Directive of 1992 but before the Market Abuse Directive, inside information was defined with reference to its likely effect on price. However, the likelihood was deemed, if a reasonable investor “would take the information into account for investment decisions”. This introduced the reasonable investor test in determining if information was inside information. The reasonable investor test is retained in the new Investor Protection Enhancement Law passed to transpose the Market Abuse Directive.<sup>21</sup>

The reasonable investor test is arguably a rather different test from price-sensitivity for inside information. For example, the reasonable investor test is also used in the United States, and has been a subject of litigation and much uncertainty. The test adopted in the US is whether there is a substantial likelihood that a reasonable shareholder would consider the information important in deciding how to exercise his rights attached to the shares.<sup>22</sup> Research in behavioural finance theories now show different investors responding to different information in different ways.<sup>23</sup> Much work has also been done in behavioural finance to suggest that how shareholders come to trading decisions is entirely random and irrational.<sup>24</sup> Thus, the standard of a reasonable investor is arguably out of place with reality. Furthermore, the reasonable investor test would have to grapple with issues of the context of information, and whether the “total mix” of contextual information would affect the price-sensitivity of any specific piece of information.<sup>25</sup> The test of investor contemplation is anchored on *an investor’s likely behaviour*, while the price-sensitivity test is anchored on a more “averaged” spectrum of investor behaviour, to ascertain if a piece of information would be likely or otherwise to

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<sup>21</sup> The AnSvG.

<sup>22</sup> *TSC Industries Inc v Northway Inc* 426 US 438 at 449 (1976).

<sup>23</sup> Robert Prentice, “Whither Securities Regulation? Some Behavioural Observations Regarding Proposals for its Future” (2002) 51 Duke Law Journal 1397; Donald C Langevoort, “Selling Hope, Selling Risk: Some Lessons for Law from Behavioural Economics About Stockbrokers and Sophisticated Customers” (1996) 84 California Law Review 627 which argues that investor preferences are largely shaped by trust in specific intermediary advice.

<sup>24</sup> Robert J Schiller, *Irrational Exuberance* (Princeton University Press 2000) at 135 and 148ff.

<sup>25</sup> *Folger Adam Co. v. PMI Indus., Inc.*, 938 F.2d 1529, 1533 (2d Cir. 1991)

affect share price.<sup>26</sup> It is uncertain how the German BaFin and courts would interpret “inside information” as the statute allows both the price-sensitivity test and the reasonable investor test to be used.

The interpretation of terms may also be subject to judicial interpretation, and not merely regulator administration, and thus, judicial interpretation could differ from Member State to Member State. In the absence of augmenting the status of CESR’s interpretive guidelines, judicial interpretation of discretionary terms in securities laws could entrench divergences between Member States.

Evaluating regulatory convergence in the interpretation of EU securities laws using the cybernetic model, each regulator and national court has the autonomy to determine how securities laws are to be interpreted and administered, creating a multitude of *selectors* for the norms of regulatory interpretation and administration. The administration and interpretation of securities laws would likely follow the multiversalist effect in the sources of laws, and become divergent and fragmented. Regulatory convergence in the interpretation and administration of securities laws may only be controlled if the norms for interpretation are set by CESR, providing a uniform *selector* for *effecting* regulatory administration and interpretation. Although there would still be a multitude of *effectors*, the network influence of CESR and the technical nature of applying securities laws may encourage Member States to converge with CESR’s guidelines. As CESR’s recommendations are not *de jure* binding, these norms do not sufficiently amount to “norms” within a cybernetically self-sufficient system to direct convergent interpretation and administration. As such, these recommendations may not cybernetically affect the actions of the *effectors*, who apply the

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<sup>26</sup> Joan Macleod Heminway, “Materiality Guidance in the Context of Insider Trading: A Call for Action” (2003) 52 American University Law Review 1131.

laws. The level of control required in a cybernetically self-sufficient system is arguably lacking for regulatory convergence in the interpretation and administration of securities laws.

### **3. Regulatory Convergence in Supervision by Member States**

“Supervision” is different from enforcement, as supervision is a process of monitoring to *prevent* abuse, and involves more informal relationships and communications between the regulator and regulated. Enforcement would be a stage where the regulator’s relationship with the regulated becomes more starkly polarised, and punishment is sought for an abuse that has become publicly defined as such.<sup>27</sup> Supervisory convergence largely relates to: “how regulators approach the practical operation of rules and legislation[;] [c]onvergence of both supervisory objectives and techniques will be achieved by sharing these objectives and techniques to secure a common approach across Europe.”<sup>28</sup> CESR envisages that supervisory convergence will contribute to the uniformity of enforcement practices and a “European jurisprudence” in securities regulation in due course.

Supervision is currently carried out by home country control, and it will be argued that home country control is inherently antithetical to supervisory convergence. It will also be argued that supervisory convergence may be undermined by the existence of areas of shared and overlapping supervisory competence provided in the substantive laws.

#### ***3.1 Home Country Control***

Home country control is the corollary of the passport regime of liberalisation found in the Directives. The “passport” means that once a regulated entity is approved by a home Member

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<sup>27</sup> John H Walsh, “Regulatory Supervision By The Securities And Exchange Commission: Examinations In A Disclosure-Enforcement Agency” (1999) 51 Administrative Law Review 1229.

<sup>28</sup> CESR Himalaya Report of 25 Oct 2004, at para 2.4.

State, it would be accepted in a host Member State to provide services or establish a branch based on the home Member State's approval. However, the home state will have to undertake continuous supervision and enforcement against its regulated entities.<sup>29</sup>

Home country control means that supervision is undertaken by the responsible home state for its issuers, authorised intermediaries and markets, wherever the regulated may operate. Home country control may be a convenient way of designating responsibility but it is not without problems. Under the old ISD, a system of home country and shared control existed in supervision over cross-border entities. Securities intermediaries were governed by home competent authorities in terms of authorisation and prudential requirements. However, conduct of business regulation such as disclosure, "knowing your client" and client protection measures were governed by the host Member State. This engendered some critique against the ISD as the same investment firm had to comply with many different sets of conduct of business rules in different Member States, and this limited their freedom of establishment.<sup>30</sup> Regulatory arbitrage may also occur, where intermediaries sought to take advantage of the differences between more stringent and less stringent supervisory regimes.<sup>31</sup> With this in mind, the current substantive laws have opted overwhelmingly for home country control.

In order to streamline home country control practice, the regulators of CESR have agreed to a Multilateral Memorandum of Understanding to facilitate cooperation and assistance in the supervision and investigative activities that home authorities have to carry out.<sup>32</sup> CESR has also established permanent operational groups within the CESR infrastructure to ensure the exchange of information and rendering of assistance in accordance with the MoU. There are

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<sup>29</sup> Article 17, Prospectus Directive, Articles 31-34 and 43(6), MIFID, Articles 6-6b, UCITS.

<sup>30</sup> Manning Gilbert Warren III, "The European" (1994) "The European Union's Investment Services Directive" (1994) 15 University of Pennsylvania Journal of International Business Law 181.

<sup>31</sup> Emiliós Avgouleas, "The Harmonisation of Rules of Conduct in EU Financial Markets: Economic Analysis, Subsidiarity and Investor Protection" (2000) 6 ELJ 72. See also Eddy Wymeersch, "The Implementation of the ISD and CAD" in Ferranini (ed), *European Securities Markets* (The Hague: Kluwer Law International 1993) at 3.

<sup>32</sup> See [www.cesr-eu.org](http://www.cesr-eu.org).

2 permanent operational groups established for supervision and enforcement. One is CESR-Pol which facilitates “effective, efficient and pro-active sharing of information, in order to enhance the co-operation and the co-ordination of surveillance and enforcement activities between CESR”.<sup>33</sup> The other operational group is CESR-Fin that carries out surveillance and facilitates enforcement against breaches in the reporting of financial information.

One commentator has argued that home country control undermines the objective in regulatory convergence i.e. facilitating free movement of capital. Home country control requires elaborate coordination between Member States, which may not be easily achieved for effective supervision, notwithstanding the aspirations in the MoUs.<sup>34</sup> This thesis suggests that home country control is essentially antithetical to supervisory convergence, and that the efforts of CESR are insufficient to exercise control over the achievement of supervisory convergence in a cybernetic model of analysis.

### ***Home Country Control as Antithetical to Supervisory Convergence***

First, home country control is a ripe area for regulatory competition instead of convergence. Regulatory competition is the idea that Member States with different regulatory frameworks can compete for capital, and the regulatory framework that attracts more capital may be more competitive than others.<sup>35</sup> Member States are not only likely to compete for intra-EU capital but also for foreign capital such as from the US. The home country control system assumes that capital issuers or investment firms would probably originate from one of the Member

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<sup>33</sup> See CESR website at <http://www.cesr-eu.org>.

<sup>34</sup> Mads Andenas, “Who is Going to Supervise Europe’s Financial Markets?” in M Andenas and Y Avgerinos (eds), *Financial Markets in Europe* (The Hague: Kluwer Law International, 2003) at xxii.

<sup>35</sup> Wolfgang Kerber, “Inter-Jurisdictional Competition Within the EU” (1998) 23 *Fordham International Law Journal* 217; Horatia Muir Watt, “Experiences From Europe: Legal Diversity and the Internal Market” (2004) *Texas International Law Journal* 429 (2004). Some undesirable effects of regulatory competition such as regulatory arbitrage and race to the bottom are discussed in Amir Licht, “Regulatory Arbitrage For Real: International Securities Regulation in a World of Interacting Securities Markets” (1998) 24 *Yale Journal of International Law* 61; Richard L Levesz, “Federalism and Regulation: Some Generalisations” in Daniel C Esty and Damian Geradin (eds), *Regulatory Competition and Economic Integration* (Oxford: OUP 2000), Gerhad Hertig, “Regulatory Competition for EU Financial Services” in D Esty and D Geradin (eds), above .

States, so that the home tie could easily be established, and the home country could continue to supervise the cross-border entities of that approved entity with assistance from information-sharing amongst regulators, and the eyeballing efforts of CESR-Pol and CESR-Fin. This assumption is a simplistic one as it does not fully address the possibilities of choice in selecting the home regulator.<sup>36</sup>

### ***Pan-EU Entities***

Establishing a home tie may be difficult for capital issuers which are already pan-European or multinational corporations, with a group structure. Any one of the group could be an issuer, or the group may set up Special Purpose Vehicles (SPVs) to issue securities. The freedom of establishment laid down in the *Centros*<sup>37</sup> decision would allow maximum flexibility as to where corporate vehicles are to be incorporated. The territorial registered office of the SPV may become the home tie and such a registered office may not be the “real seat of business”. Thus, pan-EU entities have some latitude in selecting their home regulator, and this may incentivise regulators to compete to be the choice Member State of incorporation.

Competition may encourage regulators to innovate and provide differences between their administration, supervision and enforcement of securities laws. CESR has also acknowledged the possibility of regulatory arbitrage in selecting a home tie.<sup>38</sup>

### ***The “SE”***

Another example of a European company that may be free to select a home regulator is that of the “SE”. The European company or “SE”<sup>39</sup> allows a public company in a Member State

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<sup>36</sup> See also George Wittich, “Implementing the Lamfalussy Report: The Contribution of Europe’s Securities Regulators” (2001) 3(6) JIFM 209.

<sup>37</sup> Case 212/97, *Centros Ltd. v. Erhvervs- og Selskabsstyrelsen* (ECJ, 9 March 1999) [1999] 2 CMLR 551.

<sup>38</sup> This point is acknowledged by CESR in their Level 3 Recommendations on Implementing the Prospectus Directive, no. 809/2004, found on <http://www.cesr-eu.org>.

<sup>39</sup> Council Regulation 2157/2001, which entered into force on 8 Oct 2004. See discussion in Frank Wooldridge, “The European Company: The Successful Conclusion of Protracted Negotiations” (2004) 25 Company Lawyer 121 and Erik Werlauff, “The SE Company: A New Common European Company from 8 Oct 2004” (2003) 14 EBLR 85.



to be formed as an “SE” and enjoy public limited liability status in every Member State. An “SE” needs to have a registered office and it could be conceivable that an SE may reincorporate in another more attractive Member State.<sup>40</sup> It is quite ironic that an SE needs to establish a home tie, as it is meant to be pan-European in nature.<sup>41</sup> However, as there is no pan-European supervisor or enforcement agency for EU securities regulation, the SE needs to have a home regulator. As with the point raised above regarding pan-EU entities with a large group structure, the SE may also have the choice of reincorporation, and that could incentivise regulatory competition amongst Member States.

### ***Foreign Issuers***

Next, the Prospectus Directive does not address how third country foreign issuers may establish a home tie and then take advantage of the passport to make public offers of securities across Europe. Foreign issuers can clearly choose where in the EU they may wish to incorporate, and may exploit the regulatory arbitrage.<sup>42</sup> The possibility of “forum shopping” for the most desirable home Member State is also opined by practitioners.<sup>43</sup> National regulators wishing to attract foreign issuers which could be a source of direct or indirect investment, could introduce differences in the administration, supervision or enforcement of securities laws.

However, although there may be an impetus towards regulatory competition for issuer or investment firm incorporation, Member States would only engage in regulatory competition

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<sup>40</sup> Although some studies suggest that reincorporation may be rare and difficult, see Eva Maria Keininger, “The Legal Framework of Regulatory Competition Based on Company Mobility: the EU and US Compared” (2004) 6 German Law Journal 741, Jeanne-Mey Sun and Jacques Pelkmans, “Regulatory Competition in the Single Market” (1995) 3 JCMS 67. Other studies suggest that business decisions to reincorporate depend heavily on the type of industry and mobility of assets and thus, it is too simplistic to generalise the cost of reincorporation as always forbidding to businesses. See Dale D Murphy, *The Structure of Regulatory Competition: Corporations and Public Policies in a Global Economy* (Oxford: Oxford University Press 2004).

<sup>41</sup> Patrick Jenkins and Tobias Buck, “A Corporate Statute with Fewer Limitations” *Financial Times* (10 Oct 2005).

<sup>42</sup> Iris H-Y Chiu “Three Challenges Ahead in the Future of EU Securities Regulation” (2006) 17 EBLR 121.

<sup>43</sup> J Bartos, M.A. Leppert and W.B. Reynolds, “The EU Prospectus Directive- A Home Member State for Non-EU Issuers” (2004) 18(2) *Insights* 32.

if the benefits to be achieved from attracting incorporation outweigh the cost. Attracting incorporation may generate revenues from corporate tax, but this may not be significant revenue. Further, attracting incorporation entails the corollary burden of supervision and enforcement, and thus, there should not be an assumption that Member States would rush to diversify their regulatory practices in order to compete. If the competition is for reincorporation of European entities, recent research suggests that reincorporations are rather costly and firms may consider if the cost of reincorporation outweighs the short term benefits of slightly lower regulatory cost.<sup>44</sup> However, if attracting incorporation brings about significant foreign direct investment, especially for developing European jurisdictions, this may incentivise regulatory competition among Member States to attract foreign and pan-EU issuers.<sup>45</sup>

Supervision is essentially a more private and informal process between the regulator and regulated. If Member States are incentivised to carry out regulatory competition, the nature of supervision could easily give rise to regulatory fragmentation in terms of supervisory efficacy and the supervisory style between home regulators.

### *Norms for Supervisory Convergence?*

Early CESR initiatives and efforts were arguably not directly relevant to securing supervisory convergence. This relates to the norm-setting aspect of the cybernetic model of analysis, and the question is whether there are norms set to direct regulatory convergence in supervisory practices. CESR instituted Memoranda of Understandings for information sharing arrangements between Member States in order to assist the actual regulatory efforts

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<sup>44</sup> Keininger, "The Legal Framework of Regulatory Competition (2004), op cit at n40.

<sup>45</sup> Claudia M Buch and Christian Pierdzioch, "The Growth and Volatility of International Capital Flows: Reconciling the Evidence" in H Siebert (ed), : *Challenges for Economic Policy* (Berlin: Springer 2001) at 3. See also Leslie Hull and Linda L Tesar, "The Structure of International Capital Flows" in Siebert, above, at 90.

undertaken by Member States. They do not arguably affect the differences in regulatory practices undertaken by different home regulators. CESR-Pol and CESR-Fin help to render assistance in identifying enforcement opportunities for the home regulator, and were not actually involved in providing norms for supervisory convergence. In 2006, their mandates were expanded<sup>46</sup> to include active monitoring of regulatory developments in Member States and influencing Member State regulators to adopt convergent supervisory practices. It is thus too early to tell to what extent they may actually influence regulators to adopt similar supervisory and enforcement styles and methodology.<sup>47</sup>

With information sharing, regular contact and regulatory monitoring within CESR, national regulators may be influenced to achieve a general similarity in the standards and efficacy of supervision, and that reduces the potential for arbitrage. However, regulator styles are very important for the regulated. With the rise of administrative methods in securing compliance such as negotiated penalties,<sup>48</sup> regulators have many options in dealing with their regulated entities, from dialoguing, to warning, to trading penalties off for certain behaviour.

Divergences in regulatory style would be significant to the regulated. In particular, the UK's principles-based style, with frequent dialoguing with the industry, is arguably unique in the EU. It is arguably difficult for CESR to effectively achieve monitoring and influence over day-to-day and ongoing activities in supervision that regulators carry out, especially since the very nature of supervision is that supervision is an informal and continuous process between the regulator and regulated.

Further, home country control does not inherently guarantee supervisory convergence.

Different home countries would exercise extra-territorial control over their regulated entities

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<sup>46</sup> CESR, *Revised Terms of Reference for CESR-Pol* (2 Aug 2006) and *Revised Terms of Reference for CESR-Fin* (2 Aug 2006), respectively, available at [www.cesr-eu.org](http://www.cesr-eu.org) (accessed Nov 2006).

<sup>47</sup> CESR-Pol and CESR-Fin are increasingly looking at fostering enforcement convergence but CESR acknowledges that these efforts are in their early stages, see 2006 Report on Supervisory Convergence in the field of Securities Markets at n104.

<sup>48</sup> Karen Yeung, *Securing Compliance* (Oxford: Hart 2004).

across the EU, and this would mean, on one market in one jurisdiction, the issuers and intermediaries may be subject to different home regulators. This would result in different levels of investor protection for investors in the same jurisdiction. This is apt to cause confusion amongst investors. Home country control may also result in the national regulator “catching too little” extra-territorially or “catching too much”, and home country control exercised extra-territorially may often be criticised in terms of either over-rigour or negligibility.<sup>49</sup> CESR does not at present produce sufficient norms that deal with convergent regulatory practices as such. General mandates to CESR-Pol and CESR-Fin do not arguably amount to setting norms for regulatory convergence in supervision at the cybernetic level.

Moreover, Directives such as the MIFID<sup>50</sup> expressly allow host Member States to refuse to cooperate if the sovereignty, security and public policy of the host state may be adversely affected or where judicial proceedings have been started in the host state. Thus, the Directives provide for room for fragmentation to occur, and this is further explained in the Part below.

### *3.2 The Limits of Home Country Control*

Home country control is sometimes unsuitable because of the advantage of proximity that a host Member State may have in supervision and enforcement of a regulated entity operating in the host jurisdiction. For financial conglomerates, home country control alone may also be too distant and weak.<sup>51</sup> Thus, the substantive laws in the Directives allow some areas of shared or overlapping control between Member States. Although shared and overlapping control is reduced to a minimum in the Directives, the scope of the common regulatory space is arguably not sufficiently well-defined. As such, supervisory fragmentation may occur, and

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<sup>49</sup> E.M. Fox, “Global Markets, National Law and the Regulation of Business- A View from the Top” in M Likosky (ed), *Transnational Legal Processes: Globalisation and Power Disparities* (Cambridge: Cambridge University Press 2002) at 135.

<sup>50</sup> Article 59.

<sup>51</sup> Eva Lomnicka, “The Home Country Control Principle in the Financial Services Directives and Case Law” (2000) 11 EBLR 324.

in the absence of norms for how supervisory practices may converge, shared and overlapping supervision may exacerbate supervisory fragmentation.

### ***Power Sharing- Host State Responsibilities***

Under the UCITS, there is a division of responsibility between home and host regulators as to supervision and enforcement against a UCITS. Host states may be able to supervise and enforce against a hosted UCITS in respect of issues dealing with advertisements, dissemination of information such as prospectuses, and payments to unit holders upon redemption.<sup>52</sup> Under the MIFID, host Member States are to be responsible in ensuring that intermediaries comply with conduct of business rules such as client order handling rules, the duty to act honestly and fairly, and pre-and post trade reporting requirements.<sup>53</sup> The UCITS and MIFID also provide for periodic reporting requirements to be complied with by intermediaries to host states.<sup>54</sup> While it may be necessary for host Member States to be responsible for certain forms of supervision and enforcement, as the conduct of the regulated entity will likely affect the nationals of the host Member States, it is not clear to what extent host Member States need to converge in their practices.

Further, it is uncertain if host regulators are obliged to keep home regulators informed as to their supervision and enforcement. Passing on such information to the home regulator may be necessary so that the home state may have a “holistic picture” of supervision over any particular entity. Currently, home states also do not need to inform host states of any contextual factors surrounding their approval of intermediaries. The host regulator would benefit from such information since it has oversight of these intermediaries in respect of what the Directives have provided. Although the MoU mentioned above provides for sharing of

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<sup>52</sup> Article 49(3) UCITS Directive.

<sup>53</sup> Article 32(5) MIFID.

<sup>54</sup> Article 6c, UCITS and Article 61, MIFID.

information to assist enforcement, if no assistance is actually required, the responsible Member State need not take the initiative to share such information. The MIFID provides for inter-authority consultation before granting approval to a securities intermediary to establish business.<sup>55</sup> However, such mandatory coordination takes place at the point of approval, i.e. before the intermediary may carry on business, and thus, the “full picture” of information obtained at that point in time would only be of limited lifespan and use. The MoUs do not extend to continuous sharing<sup>56</sup> and pooling of information at the moment.

The supervision of financial conglomerates, especially intermediaries who may be part of a larger group that carries out banking or insurance business, has always been a problem of concern. The supervision of such financial conglomerates is particularly difficult because different regulators may be responsible for different aspects of the group’s business, and even in the same aspect of the group’s business, there may be different regulators sharing responsibility (such as the home/host division of responsibility over different aspects of securities intermediaries’ conduct).<sup>57</sup> The Conglomerate Directive came into force in 2002,<sup>58</sup> and established responsibility for all relevant national regulators, compelling a lead regulator to be identified. However, lead regulators do not have distinctive authority to take action. National regulators may be coordinated by lead regulators to take action, but enforcement still largely depends on collaboration and negotiation amongst national regulators, even if quick action may be needed to prevent systemic risks. The Conglomerate Directive highlights the difficulties associated with co-operation in supervision. Since supervision on an EU level requires so many *effectors*, it is inherently a difficult process without supervisory norms, and convergence is arguably an even more remote achievement. Cooperation in the long term

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<sup>55</sup> Article 60.

<sup>56</sup> See R Munoz, “Development of Ex Ante Control” in T Tridimas and P Nebbia (eds), *EU Law* (Oxford: OUP 2004).

<sup>57</sup> There is some discussion in the Symposium on Financial Supermarkets on whether a single financial regulator is needed for effective supervision, or even, a single pan-European financial regulator. See J Markham “Super-Regulator” (2003) 28 *Brooklyn Journal of International Law* 319.

<sup>58</sup> 2002/87/EC.

may however bring about stealthy steps towards convergence,<sup>59</sup> based on the influence of the network upon Members of the network. However, as of now, it is very arguable, using a cybernetic model of analysis, that there are sufficient supervisory norms to direct *effector* Member States to convergent practices. Such convergence is further threatened by overlapping responsibilities and power sharing.

### ***Power Sharing- Article 10 of the Market Abuse Directive and Precautionary Measures***

The fragmentation of supervisory responsibility is also seen in Article 10 of the Market Abuse Directive which provides for enforcement, including extra-territorial enforcement, by Member States against market abuse activity carried out on its regulated markets, and against activities on its territory whether or not relating to the markets or financial instruments it regulates.

The Article allows overlapping enforcement responsibilities. For example, if market abuse activity occurs on Member State A's regulated market, A has enforcement responsibility. The home Member State B which regulates the miscreant insider, who may be an intermediary, may also have overlapping responsibility. Further, the home Member State for the issuer whose securities have been subject to insider trading, may also have responsibility as the insider trading affects its domestic investors, albeit not carried out on its regulated markets. This Article is far from clear as to the sharing of enforcement responsibility of Member States against market abuse. Regulators each have national investors to protect, and it is conceivable that such an overlapping situation may arise, and regulators may disagree on each other's roles.<sup>60</sup> Overlapping enforcement may also be costly and inefficient.

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<sup>59</sup> The theory of stealth in European integration is recently discussed in G Majone, *Dilemmas in European Integration* (Oxford: Oxford University Press 2005).

<sup>60</sup> CESR has instituted a peer mediation mechanism to deal with disagreements generally, and this would be further discussed in Part 3.3.

Finally, it is noted that all the Directives provide for host Member States to take some forms of precautionary measures. If a home Member State has been informed to enforce and has done so inadequately, or the regulated entity has persisted in the wrong-doing, the host Member State may take precautionary measures to enforce against that entity to put an end to the irregularity. There is a potential interpretive chasm between Member States in determining what “inadequate” is. This could give rise to supervisory fragmentation between home and host regulators. Further, the extent of the powers granted under the precautionary measures is uncertain, and it is wondered if severe measures such as suspension of operation or trading may be ordered by host regulators in order to put an end to the irregularity? Such measures would directly affect the home regulator’s competence in regulating the entity concerned.

The enforcement practices of regulators in taking precautionary measures may also be affected by other governmental pressures, especially if market disorder or systemic risk may be imminent. These influences would act as potential diverging forces in supervisory practices among Member States.

### *3.3 CESR’s Role in Supervisory Convergence*

CESR has foreseen that supervisory convergence is not an easy path to thread. Issues of coordinating law in action are frequently referred to as “post-decision effects” and are likely to give rise to internal dissension within CESR.<sup>61</sup> CESR’s model for supervisory convergence is to institute a peer mediation system in order to iron out differences among regulators and provide for “acceptable solutions” to specific cases. This mechanism may also

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<sup>61</sup> “Post-decision” effects usually result in more conflict amongst groups. See Ole Elgstrom and Christer Jonsson, “Negotiation in the EU: Bargaining or Problem Solving?” (2000) 7 JEPP 684.



prevent long drawn-out arguments from escalating to the Commission or Court.<sup>62</sup> In terms of the cybernetic model of analysis, CESR has not set out up-front norms of supervisory practices for the purposes of convergence. However, it has set up a mediation dispute resolution system to provide *ex post* solutions for difficulties in supervisory fragmentation. Thus, the mediation system will be examined as to what extent it may provide a norm-setting function in the cybernetic sense to direct towards supervisory convergence, and whether the mediation process is sufficient to affect *effectors* i.e. the regulators, in the system to adopt convergent practices.

### ***The Implications of Peer Mediation in CESR***

CESR's peer mediation system<sup>63</sup> consists first of the "gatekeeper", a CESR member who is entrusted with the task of deciding whether an issue is to proceed for mediation, based on a set of agreed criteria, and second, an appointment procedure to appoint a suitable mediator from among CESR members who are part of the Mediation Panel, to facilitate an acceptable solution between disputing parties. The mediation may take on the form of an "evaluative" model where the Panel members recommend a solution. However, the evaluative model is only encouraged and not compulsory, and other forms of flexible arrangements may also be used. The outcome of the mediation will be non-binding but will be notified to all CESR members and the Chairman.

Is mediation likely to influence national regulators in adopting convergent practices in supervision? The peer mediation system instituted by CESR retains the essential characteristic of mediation, and that is the non-binding outcome. Research on the nature of

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<sup>62</sup> CESR Himalaya Report, at 11, and fleshed out further in CESR, *Report on a Mediation Mechanism* (2 Aug 2006), available at [www.cesr-eu.org](http://www.cesr-eu.org) (accessed Nov 2006), and the Annual Report, 2006.

<sup>63</sup> CESR, *Report on a Mediation Mechanism*, *ibid*.

mediation shows that mediation only arguably affects the disputing parties, and may not have wider implications for non-parties. Even then, the effects on disputing parties are arguable.

It may be argued that mediation could produce better outcomes and better relationships in CESR, and hence, mediated outcomes may become practically influential. Research shows that mediated outcomes may be *integrative* in nature, i.e win-win, in which case, they are more influential on both parties, or may be *redistributive* in nature, in which case the non-binding nature may be taken advantage of by the party on the “losing” end.<sup>64</sup> An *integrative* outcome benefits both disputing parties, while a *redistributive* outcome benefits one of the parties only and parties will tend to bargain only for their self-interests. Political scientists have researched on the factors that tend to make negotiations between actors in a group more redistributive, and the factors that make a negotiation more integrative.<sup>65</sup> Interdependence between the parties may make the outcome more integrative.<sup>66</sup> Strong pre-existing relationships and common values also affect integrative-ness.<sup>67</sup> CESR is a rather close network, with a history of working together,<sup>68</sup> and bound together by a sense of mutual dependency. However, it is uncertain if enlargement of the EU increasing representation within CESR may dilute<sup>69</sup> any strength and cohesiveness it had formerly built up with only

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<sup>64</sup> Ole Elgstrom et al, “Negotiation in the EU” (2000), op cit at n61.

<sup>65</sup> Ibid.

<sup>66</sup> Jacob Bercovitch and Allison Houston, “The Study of International Mediation: Theoretical Issues and Empirical Evidence” in J. Bercovitch ed, *Resolving International Conflicts* (London: Lynne Reiner Publishers 1996) at 11. The writers posit a “contingency theory” of different contextual factors that may affect the success of mediation.

<sup>67</sup> Cultural differences may be a real barrier to mediation being carried out successfully. With enlargement of the EU, the cultural heterogeneity is rather significant. Mediators may need additional abilities to interpret different cultural perceptions and cross the barriers of communication. See Raymond Cohen, “Cultural Aspects of Mediation” in Bercovitch (ed), *Resolving International Conflict* (1996), *ibid*. See also Carrie Menkel-Meadow who believes that multi-culturalism actually makes mediation more apt as a postmodern dispute resolution process than adversarial litigation. “The Trouble with the Adversary System in a Postmodern, Multicultural World” (1996) 38 William and Mary Law Review 5.

<sup>68</sup> Continuity in a long-term relationship lends itself to making negotiation work. See Helen Wallace, “Politics and Polity in the EU” in Helen Wallace and William Wallace (eds), *Policy-Making in the EU* (Oxford: Oxford University Press 1996).

<sup>69</sup> Matthew J.Gabel, “The Endurance of Supranational Governance: A Consociational Interpretation of the European Union” (1998) 30(4) Comparative Politics 463.

representation of 10 Member States.<sup>70</sup> Further, if the issues are more technical in nature, self-interests in distributive outcomes may unlikely surface.<sup>71</sup> Other internal or contextual factors may also affect the integrative quality of a mediated outcome. Factors such as the cause of the dispute and the level of politicisation would also be relevant to make a dispute more redistributive. Hence, the goodwill in the network of CESR may not be sufficient to guarantee integrative outcomes for its members, and hence, it is uncertain how influential the mediation apparatus may be for supervisory convergence.

Further, the process of mediation may not secure any influence over disputing parties and other regulators towards convergence. It is widely recognised that mediators have as much their own agendas as the disputants, and pure neutrality and lack of bias is rather unrealistic.<sup>72</sup> Hence, it is arguable that peers in CESR may mediate by leveraging their influence and persuading towards convergent outcomes.<sup>73</sup> However, this possibility may backfire on itself, where different peers have different agendas. It would be uncertain whether mediation may be used as a process to play out game situations within CESR, with different regulators aligning with different views. Mediator attributes<sup>74</sup> could also affect the outcomes of mediation in dispute resolution.<sup>75</sup>

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<sup>70</sup> Some studies carried out by political scientists suggest mixed reactions on the effects of enlargement on decision-making in the EU. On a more micro level, this may also affect CESR internally. See Thomas König and Thomas Bräuninger, "From an Ever-Growing towards an Ever-Slowing Union?" and Rachel Brewster, Michael Munger and Thomas Oatley, "Widening Versus Deepening the European Union: An Institutional Analysis" in Madeleine O Hösli, Adrain van Deemen and Mika Widgren (eds), *Institutional Challenges in the EU* (London Routledge 2001) at 155 and 48 respectively. The former argues that enlargement slows down decision-making in the EU while the latter disagrees.

<sup>71</sup> David Lazer, "Regulatory Interdependence and International Governance" (2001) 8 JEPP 474.

<sup>72</sup> Peter J Carnevale and Sharon Arad, "Bias and Impartiality in International Mediation" in Jacob Bercovitch (ed), *Resolving International Conflicts* (1996), op cit at n66 at 39, and William Zartman and Saadia Touval, *International Mediation in Theory and Practice* (London West View Press 1985) at 255.

<sup>73</sup> Leonard L Riskin, "Understanding Mediators' Orientations, Strategies and Techniques: A Grid for the Perplexed" (1996) 1 Harvard Negotiation Law Review 7.

<sup>74</sup> Harry M Webne-Behrman, "The Emergence of Ethical Codes and Standards of Practice in Mediation: The Current State of Things" (1998) 1998 Wisconsin Law Review 1298 questions whether mediators ought to be accredited, but this is in the context of consumers using such services. Within CESR, would it be sufficient for peers to be mediators or should certain minimum "characteristics" be ascertained?

<sup>75</sup> See also Lon L Fuller, "Mediation- Its Forms and Functions" (1971) 44 Southern California Law Review 305.

Mediation may also not be appropriate for decision-making in some issues. Although the gatekeeper may provide a decision on the mediability of an issue, the decision of the gatekeeper may not always agree with the perspectives of Member States especially if the interests involved relate to national resources or security.<sup>76</sup> If a dispute is elevated to issues of subsidiarity, how would that be resolved by mediation? It may even be arguable that CESR would not have “jurisdiction” to make an issue mediatable.<sup>77</sup> If a dispute regarding allocation of competences between the EU and Member States<sup>78</sup> arises or an issue arises regarding pre-emption of national competencies,<sup>79</sup> could peer mediation be an appropriate forum for deciding these issues? The horizontal relationships between Member States *inter se* in CESR make it difficult to resolve issues where value judgments need to be made, such as where one Member State is asked conform to a particular practice, or where a particular Member State’s practice may be regarded as exemplary or otherwise. There are no higher level norms in terms of supervisory convergence to refer to in making value judgments as to how supervision should be carried out. If fundamental issues like these may not be resolved by mediation, then peer mediation is unlikely to be the process that would provide *selection* of supervisory norms to control the Member State *effectors’* discretion.

Further, the level of control that can be achieved towards convergence by peer mediation arguably depends on the “binding quality” of the mediated outcomes. In the Himalaya Report, CESR proposed that mediation may “provide *acceptable solutions* for specific cases” and may be initiated by the Task-Forces of CESR-Pol or CESR-Fin. In its 2006 Report on the Mediation Mechanism and the Annual Report, CESR stated that its mediated outcomes are

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<sup>76</sup> *ibid*

<sup>77</sup> Denis J Edwards, “Fearing Federalism’s Failure: Subsidiarity in the EU” (1996) 44 American Journal of Comparative Law 537; Nicholas Emiliou, “Subsidiarity: An Effective Barrier Against the Enterprises of Ambition” (1992) 17 ELR 383.

<sup>78</sup> Christopher Henkel, “The Allocation of Powers in the EU: A Closer Look at the Principle of Subsidiarity” (2002) 20 Berkeley Journal of International Law 359. It is argued that from an economic point of view, subsidiarity could be viewed as an allocative mechanism for when regulation would be most efficient and effective.

<sup>79</sup> Edward T Swaine “Subsidiarity and Self-Interest: Federalism at the ECJ” (2000) 41 Harvard International Law Journal 1.

non-binding. The mediator is not entitled to impose a solution, unlike in the case of arbitration.<sup>80</sup> Thus, the use of mediation may not develop into effective decision-making and practical solutions for EU securities regulation, as mediated outcomes are not binding and will not likely have precedential value. Mediation by nature allows disputants to have some form of autonomy over the process and outcome. It is arguable that mediation *cannot of its nature* provide any norms of supervisory convergence for a cybernetically self-sufficient system.

In terms of the cybernetic model of analysis, the key problem in supervisory convergence is the *selection* of norms in order to direct towards supervisory convergence. There are two types of norms that need to be selected for supervisory convergence, one is substantive norms, i.e. what kind of supervision should be exercised, what kind of relationship should exist between regulator and regulated, and how the boundaries in shared responsibility should be defined; these norms are more prescriptive in nature, and are arguably not provided by CESR. The reliance upon mediated outcomes to provide such norms is probably misplaced, because mediation is a dispute-resolution mechanism and not a norm-producing mechanism, unless mediated outcomes have general precedential value. It is highly arguable that mediated outcomes can supply the norms for supervisory convergence.<sup>81</sup>

The other type of norms is procedural norms, i.e. what processes of cooperation and coordination should national regulators undertake on regular and *ad hoc* bases. The convergence of procedural norms may lead to gradual regulatory convergence in substantive

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<sup>80</sup> Dayle E Spencer and Honggang Yang, "Lessons from the Field of Intra-National Conflict Resolution" (1992) 67 Notre Dame Law Review 1495.

<sup>81</sup> CESR claims that mediation has taken place for some issues under the Market Abuse Directive in terms of enforcement differences. However, its 2006 Report on Supervisory Convergence in the field of Securities Markets, 06/259b (June 2006), acknowledges that limits to convergence exist in the different penalties Member States impose in enforcement, and these may not be overcome by mediation.

norms, if regulators engage in a long term learning process and dialogue with each other.

This would be the type of convergence by stealth as posited by Majone.<sup>82</sup>

CESR has provided a number of procedural norms for its outworking. Its quarterly meetings, its expert groups and regular work processes carried out by its permanent secretariat could be argued to be procedural norms in which information is exchanged and issues are identified for collaboration. The mediation apparatus could also be argued to be a procedural norm, not a *regular* process of cooperation, but rather, an occasional one should the need arise.

Further, it may be argued that procedural norms are irrelevant to the consideration of achieving convergence in a cybernetic model. Processes affect the *effector* stage of the cybernetic model, and the question is, what regulatory convergence can the *effector* processes achieve if the *selection* of substantive norms itself is absent? However, supervisory cooperation is a continuous process and there would be future and ongoing regulator interaction in cross-border cooperation. Such cooperation in the dynamics of regime forces may provide a cybernetic system of continuous feedback and modification of each regulator's behaviour. Thus, although the *selection* is weak, the continuity of the system may allow supervisory norms to evolve in the future and there could be integration by stealth.

Professor Majone who has championed an idea of economic integration by centralised functional administration on the part of the EU,<sup>83</sup> has revised some of his ideas considerably in his recent great work.<sup>84</sup> He accepts that there are many difficulties in achieving integration, and temporary divergences<sup>85</sup> may ironically provide leadership in future convergence. He also discusses the idea of integration being achieved through stealth, through negative and not positive integration, and through various forms of regulatory competition. Applying his ideas,

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<sup>82</sup> See n59.

<sup>83</sup> Majone, *Regulating Europe* (1996), op cit at n2.

<sup>84</sup> *Dilemmas* (2005), op cit at n59.

<sup>85</sup> See F Tuytschaever, *Differentiation in European Union Law* (Oxford: Hart 1999).

it may be argued that as long as the context of supervisory co-operation remains, there is room for substantive and procedural norms of supervisory convergence to evolve, and the continuing process of co-operation, learning and feedback may provide future modification of regulator behaviour and perhaps towards convergence. Stealth may be key to the evolution of a cybernetically self-sufficient system of supervisory convergence in the future

In sum, CESR has instituted processes towards supervisory convergence, although its role in setting supervisory norms remains unclear. There is however room to allow these norms to evolve as part of the learning and dialogic process within CESR. Thus, whether consistent and coherent norms will evolve clearly through the passage of time depends much on the dynamics of CESR as a regime and the mechanics of its mediation system. Under a cybernetic model of analysis, there are arguably insufficient features to *secure* supervisory convergence as of now.

#### **4. Convergence in Enforcement**

Enforcement convergence is of particular significance in EU securities regulation. The enforcement regime of each Member State shows where the potential liability of the regulated lies, and this translates into potential cost should the regulated be liable for breaches. It is arguable that such potential liability cost would be an important factor in influencing the mobility of securities participants. Differences in enforcement regimes may impede the mobility of the regulated. As this round of regulatory convergence is purposed to achieve market integration and destruction of unnecessary barriers to capital mobility, enforcement convergence arguably relates directly to the achievement of these aims.

#### ***Stringent Standards of Regulation***

As discussed in chapter 1, the substantive laws have provided generally for an upgrading of the regulatory standards in securities laws in the EU. One of the main impressions given to businesses in this round of substantive regulation is that regulatory costs would increase.<sup>86</sup> A survey of some examples of upgraded standards follows.

The Market Abuse Directive provides for *ad hoc* ongoing disclosure, which may entail high administrative costs. For example, ongoing disclosure must be made of managerial personnel's transactions of issuers' shares such as the exercise of employee share options, and of changes in the employment list of the issuer.<sup>87</sup> These requirements are rather onerous and Article 6 of the Commission Directive implementing the Market Abuse Directive has actually cut back the reporting obligations under the primary Directive. Member States are allowed to dispense with notification if the transactions do not exceed 5,000 euros, and this exception has been adopted in the German AnSvG. Further, the Market Abuse Directive requires the ongoing submission by corporations to regulators, of lists of employees who have access to inside information, in order to keep track of potential insiders.<sup>88</sup> This is likely to impose administrative cost on companies, and it has not been proved to what extent the ongoing disclosure of employee information would translate into a visible benefit to investors, therefore justifying the cost imposed on issuers. Level 2 measures<sup>89</sup> pursuant to this Article specify the details to be submitted, including the name and identity of the persons, and the reason why the person is included in the list. This possibly augments the administrative burden on corporations.

Under the Prospectus Directive, all issuers have to update their prospectuses yearly. The duty to update prospectuses yearly pertains to "all information that [corporations] have published

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<sup>86</sup> As observed in Alistair Alcock, "Market Abuse" (2002) 23 Company Lawyer 142.

<sup>87</sup> Article 6(3) and (4).

<sup>88</sup> Article 6(3).

<sup>89</sup> Article 5 of Commission Directive 2004/72/EC, of 29 April 2004.



or made available to the public over the preceding 12 months in one or more Member States and in third countries in compliance with their obligations under Community and national laws and rules dealing with the regulation of securities, issuers of securities and securities markets.”<sup>90</sup> This is unique to the EU and is arguably one of the hallmarks of the stringent new standards. The duty to update pertains not only to prospectuses approved in Member States but also prospectuses approved in third countries.

The scope of this duty is arguably unclear. This duty can pertain to merely correcting obsolete information, such as change in a director’s address. This duty can pertain further to substitution of new information for obsolete information of the same type. An example would be that a new substantial transaction be mentioned. However, would every piece of information that was in the original prospectus require replacement of new like information? Further, would new information that was not mentioned in the original prospectus be required to be provided? On the widest possibility, does this duty require a yearly production of a document like a prospectus? The production of a prospectus is a very costly matter. Costs are incurred in engaging accountants, lawyers and other professionals<sup>91</sup> to prepare the prospectus and other financial documents and information. There are also potential costs involved in liability for misstatements and omissions in the prospectus, such potential costs may be factored already into the professional fees payable for the preparation of the prospectus.<sup>92</sup> On the widest possible reading of the duty to update under the Prospectus Directive, this obligation can be very demanding and may require much expenditure for compliance.

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<sup>90</sup> Article 10.

<sup>91</sup> M Sabine has a useful chapter detailing the actual costs that are incurred in the process of engaging various professionals to prepare for a public offer. See Martin Sabine, *Corporate Finance*, (London Butterworths, 1993, 2<sup>nd</sup> ed) at chp 5(II).

<sup>92</sup> Section 397, Financial Services And Markets Act 2000.

The MIFID also provides for a set of upgraded regulatory standards for intermediaries and markets. The MIFID Commission Directive<sup>93</sup> prescribes many stringent intermediary obligations, such as information provision. A copious amount of general and specific information such as client service policy, conflict of interest policy, product information, information on client classification, charges and investment risk information, must be provided before any transaction may be entered into.<sup>94</sup> The Commission Directive also prescribes much detail on how to discharge other obligations such as identifying and preventing conflicts of interest, suitability ascertainment and best execution.<sup>95</sup> In order to ensure that each regulatory requirement is satisfied, the cost of compliance that would be incurred by intermediaries would be significant.<sup>96</sup> The potential cost of any liability that may be incurred for breaches may also increase many fold from under the previous regulatory regime.

Further, new market transparency requirements are imposed on all market operators.

Investment firms (that carry out systematic internalisation for securities that have liquid markets), MTFs and regulated markets need to provide pre-trade transparency information in terms of current bids/offers and trading depths at the offers concerned,<sup>97</sup> and post-trade transparency information of concluded transactions in terms of volume, price and time.<sup>98</sup>

Such pre and post-trade transparency information are not obliged to be received by the regulator. The regulated has the responsibility to make them available to the public.<sup>99</sup> The MIFID Commission Regulation also requires the regulated to provide consolidated

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<sup>93</sup> Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive ( MIFID Commission Directive).

<sup>94</sup> Articles 27-33.

<sup>95</sup> Articles 21-6, 35-9, 44-6 respectively.

<sup>96</sup> John Plender, "Investment Banks Size Up MIFID Challenge" (Financial Times 9 Oct 2006).

<sup>97</sup> Articles 29 and 44 of the MIFID.

<sup>98</sup> Articles 30 and 45 of the MIFID.

<sup>99</sup> CESR has made some recommendations on how this is to be done, see CESR, *Publication and Consolidation of MIFID Transparency Data* (Feb 2007), available at [http://www.cesr-eu.org/index.php?page=document\\_details&from\\_title=Documents&id=4228](http://www.cesr-eu.org/index.php?page=document_details&from_title=Documents&id=4228).

information from similar sources.<sup>100</sup> Since the responsibility for disseminating transparency information is on the regulated, the regulated may incur administrative cost in complying with the Directive. Further, the consolidation requirement may impose further cost on the regulated, as the regulated may have to incur cost in accessing other information and providing an assemblage of price transparency data. It is argued<sup>101</sup> that the regulated may take other measures to turn these obligations into business opportunities or co-opt commercial providers to be involved. However, it is uncertain how the cost/benefit of such regulation may work out. Where systematic internalisers, i.e. investment firms who routinely cancel matching orders in house, are concerned, the price transparency requirements would certainly impose two types of cost, first, administrative cost in making public its quotes and providing comparable quotes from market venues alongside its disclosure,<sup>102</sup> and second, the cost of potential loss of revenue as the publication of its quotes would force it to compete with other markets.<sup>103</sup> Where the provision of information may be regarded as unsatisfactory, the regulated incurs the potential cost of liability due to regulator enforcement.

The increase in the amount of regulatory obligations owed by the regulated means that the regulated faces increased potential liability for breaches of regulatory requirements. Hence, the enforcement differences between jurisdictions could become very significant in fragmenting the landscape of EU securities regulation. One commentator has also argued<sup>104</sup> that it is possible that the level of enforcement deficits in any particular European issue may also be linked to the level of substantive integration through law, and the sectors where such substantive integration is lower may see greater enforcement deficits on the national landscape. In this light, the risk of fragmentation may be doubly adverse as fragmentation

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<sup>100</sup> Article 32(b).

<sup>101</sup> Iris H-Y Chiu, "Delegated Regulatory Administration in EU Securities Regulation: Some Observations from the Regulation of Continuous Disclosure and Price Transparency" (2007) *International Lawyer* (forthcoming).

<sup>102</sup> Article 24, MIFID Commission Directive.

<sup>103</sup> Plender "Investment Banks" (2006), *op cit* at n90.

<sup>104</sup> Michael Dougan, "Enforcing the Single Market: The Judicial Harmonisation of National Remedies and Procedural Rules" in C Barnard and J Scott (eds), *The Law of the Single European Market* (Oxford: Hart 2002) at 153.

itself may not only weaken the convergence agenda, but may undermine the efficacy of enforcement overall.

### *Administrative/Criminal Sanctions?*

A notable point of convergence in securities regulation enforcement is the uniform recommendation of the use of administrative sanctions in all the securities Directives.<sup>105</sup> However, the caveat is that this does not prejudice the use of criminal sanctions by Member States. The first and obvious point in enforcement fragmentation is that some Member States may retain criminal sanctions for some regulatory breaches, such as insider dealing, prospectus non-disclosure or mis-disclosure. This is likely especially if they already have these regimes in place.<sup>106</sup> Thus, some Member States would have criminal and administrative sanctions against some securities breaches, some states have only administrative sanctions. Both the UK and Germany have criminal penalties against insider dealing<sup>107</sup> but the conditions for criminal offences and administrative sanctions to occur are very different in both jurisdictions. The German criminal/ administrative penalty divide is premised upon the type of intent the insider had.<sup>108</sup> The UK criminal/ administrative penalty divide is based on the type of insider concerned.<sup>109</sup> Briefly, in relation to enforcement against market abuse, some Member States use criminal sanctions only (Norway, Sweden, Austria, Germany, Greece and Portugal), some use administrative sanctions only (UK, Malta, Netherlands and France), and some use a mixture of criminal and administrative sanctions (Finland,

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<sup>105</sup> Article 14, Market Abuse Directive, Article 51, MIFID, Article 25, Prospectus Directive and Article 28, Transparency Directive.

<sup>106</sup> Although the UK has an administrative sanctions regime for market abuse, it still retains criminal penalties for breaches of disclosure requirements in prospectuses for listing. See section 84, FSMA 2000.

<sup>107</sup> Section 52, UK Criminal Justice Act, Section 38, German WpHG.

<sup>108</sup> See s39, WpHG.

<sup>109</sup> The elements to be proved in a criminal offence are more restrictive than the administrative penalty. See E Avgouleas, *The Mechanics and Regulation of Market Abuse* (Oxford: OUP 2005) at 343.

Poland).<sup>110</sup> In terms of penalty design, Member States are likely to differ greatly and this is a principal source of regulatory fragmentation. This is already picked up by CESR and acknowledged as a limit to convergence.<sup>111</sup>

### ***Lack of Further Definition in Administrative Sanctions***

Regulators may also impose different types of administrative sanctions, such as monetary penalties, withdrawal of privileges, public censure and so on, or different levels of monetary penalties.<sup>112</sup> Furthermore, regulator enforcement would differ in terms of frequency, severity and style from state to state, as regulators are likely to have different amounts of resources available and different contexts of bureaucratic and political influences surrounding them.<sup>113</sup>

The parity in the types of sanctions levied between Member States would result in differences in the perception of the severity of any breach across Member States. With home country control, different regulators are responsible for different issuers on the same market in a Member State, and the parity in the type or severity of sanctions levied by each home authority extra-territorially would create investor confusion as to what really is the level of investor protection for them. Furthermore, as discussed earlier, there are shared competencies in some areas for enforcement. Therefore, it may be argued that the regulated would not have a clear idea of what potential enforcement may be carried out against them, and investors may also have no clear idea as to the level of protection they can expect. Enforcement

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<sup>110</sup> The above information is obtained using a brief survey of the website information contained in each national regulator's website. The website links are all collectively found in [www.cesr-eu.org](http://www.cesr-eu.org).

<sup>111</sup> 2006 Report on Supervisory Convergence in the field of Securities Markets, 06/259b, June 2006, at [www.cesr.eu](http://www.cesr.eu) (accessed Oct 2006).

<sup>112</sup> For types of administrative penalties, see Australian Law Reform Commission, *Principled Regulation: Federal Civil and Administrative Penalties in Australia* (2002) at para 2.124ff. For example, Malta imposes financial sanctions only, see Prevention of Financial Market Abuse Act Cap 476, s22. Finland could impose public censures and reprimands as part of its administrative sanctions arsenal. This information is obtained from its regulator's website at <http://www.rahoitustarkastus.fi>.

<sup>113</sup> As discussed in chapter 2, Part 2.4.2.

fragmentation may adversely influence issuer and investor behaviour in the overall aim of creating more integrated financial markets in Europe.

The final problem, on a higher level, is that the Directives do not evidence thorough consideration of the complexities in the subject of administrative sanctions; what they may be used for, and what types of administrative sanctions may be appropriate for which breaches.

<sup>114</sup> The Directives also do not consider the suitability of administrative sanctions for Member States that have lower degrees of maturity in the independence of judicial processes, which are essential in supporting a sound administrative penalty system, in terms of administrative review. It may be argued that penalty design is essentially an issue for Member States and not for the EU, as penalties may arguably fall within the Third Pillar of Justice and Home Affairs and is beyond the legislative competency of the EU, and thus, there are inherent constitutional-type limits to enforcement convergence. This point will be discussed in detail in Part 4.1.

Using the cybernetic model of analysis to evaluate enforcement convergence, in the *selection* of norms for enforcement convergence, a *selection* of administrative sanctions was made. However, this *selection* is capable of wide and diverse *effectuation* as administrative sanctions comprise of myriad possibilities. This seems to be recognised by CESR, who plans to deal with this in 2 ways. First, the use of peer influence and contact, as CESR has set up the Market Abuse Review Panel and Prospectus Group to identify enforcement differences and to attempt to streamline enforcement differences. Second, CESR plans to set up enforcement databases to be consulted by all regulators. It may be argued that CESR's efforts may provide the essential features of the cybernetic system, i.e. dialogue among regulators, feedback and future modification for convergence. However, it is arguable that CESR's efforts may secure enforcement convergence as penalty design by Member States may be

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<sup>114</sup> See Yeung, *Securing* (2004), op cit at n43 at 197.

seen to be an issue falling within the Third Pillar, particularly if Member States retain a mix of criminal and administrative penalties for securities breaches, and so, there may be limited post-decision influences that can shape and modify Member States' penalty designs. Member States would be *selectors* of their own criminal law norms. The cybernetic model may also break down as feedback and modification processes within the system cannot include issues of criminal justice that Member States have already decided on. However, the peer influence and contact stimulated within the Prospectus Group and Market Abuse Review Panels may allow the cybernetic process of information gathering to affect penalty design policies by *stealth*. Hence, it remains to be seen if these groups would provide leverage for influencing convergence. The second point on databases is discussed below.

#### *4.1 CESR's Role in Enforcement Convergence*

The primary Directives are limited in prescribing detailed penalties. This may be because the Treaty principle of subsidiarity<sup>115</sup> controls the amount of action that could be taken at Community level. If Member States already have institutions for punishment and enforcement, then Member States should arguably select the appropriate penalties for breaches, and these penalties should not be prescribed top-down from the EU. National enforcement and punishment also appear to be domestic concerns, and are unlikely to give rise to concerns of economies of scale or cross-border effects, which would warrant Community level action.

Further, criminal penalties arguably fall within the "third pillar" of intergovernmental cooperation in the European Union. The third pillar relates to matters of security, justice and

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<sup>115</sup> Article 5, Treaty of Rome, Treaty of Amsterdam amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts - Protocol annexed to the Treaty of the European Community - Protocol on the application of the principles of subsidiarity and proportionality OJ 1997 C340/10.

home affairs that the Community does not have competence to legislate in. These matters are coordinated only in the Council of Ministers and any decision taken requires unanimous agreement by voting. Thus, where enforcement by criminal sanctions is concerned, it could be argued that there is *prima facie* no Community competence.<sup>116</sup> The recent case of *Commission v Council*<sup>117</sup> has however allowed some measures of Community prescribed criminal sanctions to be regarded as under the first pillar of Community competence if it furthers the objectives that necessitated Community action in the first place. However, the extent of Community competence in criminal penalty prescription is still very uncertain, as the competence could be limited to asking Member States to prescribe criminal sanctions but not being able to dictate the extent of those sanctions.<sup>118</sup> However, it could still be argued that as the Directives recommend administrative sanctions, administrative sanctions do not fall within the third pillar and thus, the Directives could have prescribed in greater detail what administrative sanctions were envisaged. Further, the Directives could also have prescribed more guidance for civil sanctions, which are totally absent from the Directives.<sup>119</sup>

CESR has already seen that the *selection* of enforcement norms by individual regulators would provide no guidance as to how convergence in enforcement can take place. However, it is of the view that national regulators may be persuaded to take convergent enforcement approaches, by peer pressure and by centralised information sharing through databases run by

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<sup>116</sup> Case 203/80, *Criminal Proceedings against Casati* [1981] E.C.R. 2595, Case 299/86, *Criminal Proceedings against Drexel* [1988] E.C.R. 1213 and Case 186/87, *Cowan v TreAsor Public* [1989] E.C.R. 195. This *prima facie* position is endorsed in Case C-176/03, *Commission v Council*, judgment of September 13, 2005

<sup>117</sup> *ibid.*

<sup>118</sup> as suggested in Case 68/88, *Commission v Greece* [1989] E.C.R. 2965. See Martin Wasmeier and Nadine Thwaites, "The 'Battle Of The Pillars': Does The European Community Have The Power To Approximate National Criminal Laws" (2004) 29 ELR 613; Simone White, "Harmonisation of Criminal Law under the First Pillar" (2006) 31 ELR 81. Some academic discussion on community criminalising of counterfeiting European currency and intellectual property protection laws show tensions in the Community's competence in prescribing criminal sanctions. See J.A.E. Vervaele, "Counterfeiting The Single European Currency (Euro): Towards The Federalization Of Enforcement In The European Union?" (2002) 8 Columbia Journal of European Law 151; Pat Treacy and Anna Wray, "IP Crimes: The Prospect For EU-Wide Criminal Sanctions - A Long Road Ahead" (2006) 28 EIPR 1.

<sup>119</sup> To be discussed later.



CESR.<sup>120</sup> To what extent can a centralised information system containing enforcement decisions become a controlling standard for national regulators to be convergent?

One commentator posits the necessity of some form of verticalisation in achieving the single market.<sup>121</sup> Verticalisation means that enforcement is provided at the pan-EU level so that the regulated entities in the entire EU are subject to the same enforcement across Member States. Excessive reliance on horizontalisation (ie enforcement by Member States) would not be effective and would only highlight the perennial tensions between Member State and EU interests.<sup>122</sup> Policy-makers however do not seem to be that concerned about enforcement convergence in terms of substantive penalty design, as emphasis seems to be placed on supervisory convergence to achieve overall regulatory convergence.<sup>123</sup> It may be argued that supervision takes place much more intensively than enforcement and supervision itself may prevent the necessity of enforcement, which is a last ditch measure used in the ongoing regulator-regulated relationship. Thus, if supervisory convergence can be forged, then enforcement disparities in the law in books may not really undermine regulatory convergence as a whole.

That said, CESR is instituting a database of enforcement decisions taken by all national regulators. The database serves as a point of reference for regulators so that they may not deviate significantly from each other's approach. The first database is already instituted under CESR-Fin to record all Member State actions in respect of breaches of the International

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<sup>120</sup> Barney Jopson and Andrew Parker, "EU Regulators look for Standard Approach" *Financial Times* (8 August 2005).

<sup>121</sup> E.M. Fox, "Global Markets" (2002), op cit at n49 that a unifying vision "from the top" is necessary and that vision must be based upon values.

<sup>122</sup> See S Weatherill, "Pre-emption, Harmonisation and the Distribution of Competence to Regulate the Internal Market" in Barnard and Scott (eds), *The Law* (2002), op cit at n104 at 41ff.

<sup>123</sup> See remarks by Jean Claude Trichet, President, ECB and Gerrit Zalm, Chair of the Ecofin and Minister of Finance of the Netherlands at CESR inaugural conference, *Europe's Single Market- Under Construction or Fully Integrated?* held on 6 Dec 2004, at the Bourse, Paris. They remarked that some form of "supervisory convergence" should be engineered at CESR level.

Accounting Standards in financial reporting. There however is no official precedential authority in the database.

In terms of cybernetic analysis, the database may serve to narrow down the *selection* of enforcement norms, and also provides a process for information, feedback and learning that may encourage *effectors* to converge. However, as the database decisions are of no precedential value, it is questionable if the database decisions amount to norms in the cybernetic sense. The horizontal relationships in CESR make it difficult to impose value judgements on the superiority or inferiority of Member States' enforcement standards, and hence, amassing information alone cannot provide any credible norm-setting for regulators to follow. Moreover, the database is a weaker process in controlling Member State *effectuation* than the mediation process mentioned above, as there are no procedural norms on the use of the database and what the influence of the database should be. Thus, the database would not act as a sufficient process of control for national regulators to converge in enforcement practices. Besides, the incentives for regulator divergence in enforcement are probably greater than in supervisory convergence, where cross-border effects may compel regulators to cooperate. Enforcement is quite at the heart of national interest, and relates to national resources in designing penalty regimes, national courts and punishment institutions, and national procedures. As such, divergences between national regulators are likely to occur due to the different needs of Member States.

Further, even if national regulators consult the database, they could adopt an "equivalencies" approach in convergence and not literal convergence. An equivalencies approach would mean that the enforcement practices and policies need not be totally convergent in form and substance, so long as they are rather equivalent in nature and severity. For example, if Member State X levies sanctions of an administrative nature against a certain type of securities breach, and Member State Y does the same, it may not matter that X uses

administrative fines and Y uses administrative censures. However, from the perspective of the regulated, uniformity would be less confusing and perplexing than equivalencies. Equivalencies could also be argued to be an excuse to allow national differences to remain. However, the notion of equivalencies is rooted in proportionality in EU law, and total harmonisation may not be justified by Treaty competencies.<sup>124</sup> Thus, the equivalencies approach presents another constitutional-type obstacle to securing enforcement convergence.

A twist in the plot however occurred in August 2005 as the US SEC wishes to examine if European companies complying with the International Accounting Standards in financial reporting should be given equivalent treatment in the US. One factor that would influence the SEC into giving equivalent treatment is that the International Accounting Standards should be enforced uniformly throughout the EU and in a stringent manner. National regulators faced with this pressure seem to be more geared up towards actual convergent enforcement in financial reporting and CESR is proud to report that the CESR-Fin database contains 46 decisions by October 2006, and is being consulted by Member States.<sup>125</sup> If factual developments go along a high level of convergence in financial reporting enforcement, then a pattern could be established across other securities enforcement in due course. Again, in enforcement convergence, although it appears that there may be constitutional obstacles to convergent *selection* of enforcement norms, and *effectuation* of those norms, the continuous co-operative effort of CESR may provide the procedural framework in the cybernetic model for dialogue, feedback, learning and modification of each regulator's policies. Such a process may produce convergence in the future by stealth. In terms of the cybernetic systems analysis, the database does not guarantee control in securing national regulators' compliance as of now.

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<sup>124</sup> In the light of the *Tobacco Advertising Ruling*, it would even be more difficult to argue for total harmonization measures in the EU. See Case C-376/98, *Germany v European Parliament* [2000] ECR I-8419.

<sup>125</sup> Annual Report 2006, at [www.cesr.eu](http://www.cesr.eu) (accessed Oct 2006).

There are a few other issues in enforcement convergence to be discussed. First, the existence of common investor redress routes may provide a supporting structure for enforcement convergence. Second, enforcement convergence has to address the issue of civil enforcement for securities breaches.

#### *4.2 Commonality of Investor Redress Procedures*

##### *Investor Compensation*

Although there is the potential for enforcement fragmentation, such fragmentation may be minimised if supporting structures such as common investor redress procedures are established. The old securities Directives did not provide for any mandate to Member States to establish out of court settlement systems for investors who have been aggrieved, which could be very useful to investors in having an easier and perhaps cheaper way of redressing their grievances. Then the Investment Services Compensation Directive<sup>126</sup> was enacted in 1997 to provide for consumers a compensation fund similar to the concept of a deposit guarantee in the event of bank failure. The Directive deals with the issues of: who is covered under the compensation schemes, how claims are to be made and minimum payout. The Directive provides some form of uniform consumer protection against intermediaries who default. However, investor compensation is limited to defalcation committed by intermediaries, and the fund does not help investors whose investment grievances have to do with market abuse or issuer failure.

##### *FIN-NET/ SOLVIT*

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<sup>126</sup> Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes OJ 1997 L84/22.

The MIFID now provides that Member States should set up out of court settlement systems to provide redress for investor grievances against intermediaries, so that it would be more cost-effective and less cumbersome for investors to bring intermediaries to account.<sup>127</sup> If a system of out-of-court dispute resolution services can be uniformly set up in all Member States, that would provide a degree of enforcement convergence for from investors' perspective. This would be an improvement over the current SOLVIT, previously known as FIN-NET,<sup>128</sup> which is a coordinated system allowing any person in one Member State to lodge a complaint at his Member State's SOLVIT centre, against an entity another Member State, with regard to cross-border disputes in the Internal Market. Investors aggrieved by the services of a cross-border financial intermediary can therefore lodge a complaint against an intermediary using SOLVIT. The complainant's home SOLVIT centre forwards the claim to the counterpart SOLVIT centre in the other Member State, who then is responsible for deciding whether to take on the case and how to facilitate resolution of the matter. SOLVIT centres have a maximum deadline of 10 weeks to respond and are supposed to work together with the complainant's SOLVIT centre. However, there is no guarantee that a lead SOLVIT centre will take on the case or provide an acceptable solution. There are also no clear procedures for SOLVIT centres to coordinate their work on cases.

Furthermore, if cross-border disputes may be settled by alternative dispute resolution, the question would be whether any settlement outcome may be enforced against an intermediary in another jurisdiction if there are assets in that jurisdiction. This may be possible if arbitration is used by both parties and the jurisdiction where the arbitral award is sought to be enforced is a party to the New York Convention for Reciprocal Recognition and Enforcement of Foreign Awards 1958. However, not all EU Member States are New York Convention signatories, and so, although the EU is intended to be one market, where enforcement of an

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<sup>127</sup> Article 53.

<sup>128</sup> The working of SOLVIT can be found on the European Parliament website, [www.europarl.eu.int](http://www.europarl.eu.int).

arbitral award is concerned, it may not be that straightforward. If other alternative dispute resolution methods were used, such as mediation, then the SOLVIT centre is powerless when it comes to enforcing an agreed settlement. It has been commented<sup>129</sup> that the Internal Market lacks the supporting infrastructure of a convergent and common consumer protection platform, and this will arguably impede the result that regulatory convergence intends to achieve: a seamless capital market across Europe. This issue may also arguably fall within the Third Pillar of Justice and Home Affairs and hence, there may be limits to achieving a uniform structure for investor redress that could compliment enforcement convergence. The MIFID does not provide for the exact procedures for out-of-court enforcement, and Member States may rely on the SOLVIT centres to fulfil the Directive's mandate. Investor enforcement in the EU may remain weak for the lack of effective alternative dispute resolution structures and the forbidding cost of private litigation.

#### *4.3 Lack of Provision for Details of Civil Enforcement*

A number of commentators have opined that the provision for civil enforcement in securities laws is key to investor appraisal of a regulatory system.<sup>130</sup> As one of the aims in financial market integration is to encourage greater investor participation across EU markets, it would be appropriate to examine if regulatory convergence in the EU is concerned with enforcement convergence in terms of civil sanctions.

For liability resulting from Prospectus breaches, the Prospectus Directive provides that Member States should provide that persons responsible for the prospectus should be civilly liable to investors<sup>131</sup> and the Transparency Directive also has a similar provision in respect of

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<sup>129</sup> Guido Alpa, "The Harmonisation of the EC Law of Financial Markets in the Perspective of Consumer Protection" (2002) 13 EBLR 523.

<sup>130</sup> R La Porta, F Lopez-De-Silanes and A Shleifer, "What Works in Securities Laws" (2006) 71 Journal of Finance 1.

<sup>131</sup> Article 6(2).

periodic disclosure.<sup>132</sup> The UCITS Directive does not contain that at all. The “persons responsible” are not identified and thus, it is up to Member States to identify who they may choose to be regarded as “responsible”. It is common in some jurisdictions to affix responsibility of prospectus non-disclosure or mis-disclosure to persons other than the issuer.<sup>133</sup> The persons usually called to account are directors, management directly responsible for the preparation of the prospectus, underwriters and auditors for the parts they are responsible for. The difference is important as it means that certain groups of people may have potential liability and may charge the issuer greater fees in covering for that potential cost. This would make the prospectus preparation process more expensive, and cost of preparation of a prospectus could be a form of barrier to entry to an issuer contemplating making public offers. Although there is cybernetic *selection* of the norm that civil enforcement should be available, again, the *selection* is arguably weak as it leaves much of the gaps to be filled in by the *effectors* themselves, i.e. the national regulators. Besides, the Directives also do not state if the “responsible persons” would also be liable in criminal or administrative terms.

The provisions in the Directives for civil actions against issuers also do not go into any detail in terms of defining what is actionable and the *locus standi* of the aggrieved. It may be argued that this is left to the private law of each Member State to sort out and the Directives cannot be taking on the role of harmonising private or procedural law. For example, in Germany, the basis for prospectus breaches in civil liability may be based on tort or the prospectus legislation,<sup>134</sup> and it is still uncertain whether fault may need to be proved.<sup>135</sup> The

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<sup>132</sup> Article 7.

<sup>133</sup> For example, section 254 of the Singapore Securities and Futures Act imposes civil liability for prospectus misstatements on directors and underwriters. This is based on and similar to section 729 of the Australian Corporations Act 2001.

<sup>134</sup> Articles 45-48 Stock Exchange Law, and Article 13, Securities Sales Prospectus Law. (Verkaufsprospektgesetz –VerkProspG). Tort liability may be based on Article 824, 826, BGB. See N Horn, “Banks’ Duties to Inform and to Give Advice under German Law” (1998) 19 EBLR 367.

<sup>135</sup> Thomas M.J. Möllers, “Changing European Capital Market Law: A Progress Report on Information Duties in Capital Market Law from A Comparative Law Perspective” (2004) 19 JIBLR 199.

implications of harmonising civil liability for securities breaches may go far beyond the mandate of the Internal Market. The issues that are pertinent include the level of civil damages, or type of civil remedies, and even the civil procedure for how a civil liability action may be conducted, completed or settled, including whether class actions may be allowed. No doubt, the differences in civil liability regimes represent different levels of investor protection for investors,<sup>136</sup> and would certainly add to enforcement fragmentation. This is an area where enforcement fragmentation is likely to occur without the securing of *selected norms* for civil liability and control over the *effector* processes by Member States.

In sum, it has been argued that enforcement convergence is likely to be important to the overall aim of integrating securities markets in the EU. However, enforcement convergence is limited by the constitutional limits placed on the EU to *select* enforcement norms for Member States, and CESR's limited capabilities in influencing *effectuating* processes of enforcement by regulators. CESR's enforcement database is the only mechanism that may, with stealth, provide a cybernetic means for influencing the *effectuation* processes through information sharing and feedback. In the three aspects of regulatory convergence in administration, supervision and enforcement, the evaluation of the methodologies and processes in all aspects seem to indicate that the processes and methodologies fall short of securing a cybernetically sufficient system in administration convergence, supervisory convergence and enforcement convergence. The prospects for supervisory convergence by stealth seem to be the strongest out of the three, applying the cybernetic model of analysis. However, as regulatory convergence is a concept that comprises all 4 aspects of regulation, on the whole it may seem that "regulatory convergence" in EU securities regulation, as evaluated by the cybernetic model of analysis, is a rather weak phenomenon.

## 5. Conclusion

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<sup>136</sup> Ellis Ferran, *Building an EU Securities Market* (Cambridge: Cambridge University Press 2004).



This chapter has discussed three aspects of regulatory convergence in the interpretation and administration, supervision and enforcement of the EU securities laws. In interpretive convergence, CESR's guidelines and standards are immediately relevant to securing convergence, but the soft law nature of such guidelines and standards puts in doubt their effectiveness as the *selected* norms in a cybernetically self-sufficient system to guide *effector* implementation of those norms. Where supervisory convergence is concerned, the lack of *selected* norms is contrasted with CESR's efforts to institute *effector* processes towards convergence. The lack of clear *selection* may *prima facie* affect convergence as there are no yardsticks to converge on. However, the procedural aspects of supervisory co-operation and interaction may provide a foundation for cybernetic processes of feedback and modification to occur and may allow for the evolution of stealthy convergence. Enforcement convergence also faces the difficulty of weak *selection* of norms due to constitutional limits on EU level prescription for penalty designs. However, CESR's efforts in maintaining an enforcement decisions database may provide a procedural framework for the cybernetic processes of feedback and information-sharing to occur. This may allow for future evolution of convergence by stealth. In all respects of regulatory convergence, there are insufficient elements to show that cybernetically self-sufficient systems exist as of now to direct towards achievement of convergence. In the next chapter, this thesis will discuss at a higher level, whether there is an overall lack in the EU of a regulatory system for securities laws at the EU level. The penultimate and last chapters will discuss the divergent incentives for Member States and how theories of institutionalisation may provide an alternative to securing regulatory convergence.

## **Chapter 4**

### **Is There an EU Level System for Regulatory Convergence?**

#### **1. Introduction**

The foregoing chapters have discussed the four aspects of regulatory convergence, and used a cybernetic model of analysis to examine to what extent convergence may be secured in the current regulatory framework. This chapter brings the discussion to a higher level, and intends to examine if there is a system at the EU level to direct towards regulatory convergence as a whole. It could be said that chapters 2 and 3 have taken a “functional” perspective, in examining if each regulatory aspect of “regulatory convergence” may be forged towards convergence. In this chapter, a more “institutional” perspective is taken, to examine if there is an overall structure already in place to drive towards convergence. The institutional perspective is important as an overarching structure that is in place may help to address the functional gaps that have earlier been identified.

By “system”, the inquiry is to find out if there is an organised arrangement at the EU level for organising EU level governance towards regulatory convergence. The “system”<sup>1</sup> can be a unified arrangement, or an aggregate of several centers of governance which functions as an organised set.

The theory of cybernetics would again be immensely useful here in evaluating if there is an EU securities regulation system that is able to organise all four aspects of regulatory

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<sup>1</sup> A generic definition of “system” can be found in the Oxford English Dictionary, as “[a] set or assemblage of things connected, associated, or interdependent, so as to form a complex unity; a whole composed of parts in orderly arrangement according to some scheme or plan; rarely applied to a simple or small assemblage of things”, a simpler version can be found on [www.dictionary.com](http://www.dictionary.com), which generally provides that a system is an arrangement that provides an organized set, or a cohesive whole.

convergence as a whole. In order to evaluate if there is such an EU level system, the chapter will examine if there are the following features:<sup>2</sup> norm-setting for the entire system, control over the execution of the norms in order to attain the objectives of the system, information-gathering by observing and measuring the performance of the system, and securing compliance.

First, there is no EU agency to administer EU securities regulation. A system may be more easily ascertained if there is an EU agency, as the EU agency would likely be regarded as the *selector* of the norms within the system and the other actors who interact with the *selector* can be readily identified. It is arguable that there is a pan-European regulatory system for regulatory convergence, in the form of the Lamfalussy process, or in the form of CESR's governance. This chapter will examine if either amounts to a cybernetic system at the EU level for regulatory convergence as a whole. It will be argued that neither amounts to an EU level system for EU securities regulation, as the Lamfalussy process lacks *continuity* as a revolving system for EU securities regulation, and CESR's governance lacks *regulatory control*.

## **2. The Lamfalussy Procedure as a System for EU Securities Regulation?**

The cybernetic model of analysis will be applied to examine the features of the Lamfalussy process. The arguments are summarised as follows:

In terms of the norm-setting aspect, there are two fundamental failures in the Lamfalussy process. First, there is no institutionalisation or continuity in the norm-setting process found in Levels One and Two of the process, which relate to law reform. Levels One and Two appear to be one-off in nature, and are not institutionalised as a way of securities regulation.

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<sup>2</sup> J Black, "Enrolling Actors in Regulatory Systems: Examples from UK Financial Services Regulation" (2003) Public Law 63 and "Critical Reflections on Regulation"(2002) 27 Australian Journal of Legal Philosophy 1.

One essential characteristic of a cybernetic regulatory system is that there is certainty in its norm selection, and this presupposes either a certain authority to set norms or a permanent procedure to set norms. The lack of institutionalisation of Levels One and Two of the Lamfalussy process means that no permanent authority or procedure to set norms can be found in Levels One and Two. This does not mean that there is no default norm-setting for EU securities regulation at the EU level. The community method of legislation still applies, and emergent methods of norm setting through soft law may arguably apply as well.<sup>3</sup> However, this means that the Lamfalussy process itself is probably incapable of being described as a system for EU securities regulation. Second, as the Lamfalussy process is unlikely to be the *selector* for norm-setting in the EU securities regulation system, one falls back on the general community method as the *selector*. However, the community method, as argued in chapter 2, actually brings about a multitude of *selectors* and thus, norm-setting is both unclear and confusing. As such, one essential feature of a cybernetic system is lacking for there to be an “EU securities regulation” system.

As to the control of the application of norms within the system, the Lamfalussy process provides for Level Three measures to oversee national implementation and enforcement of EU securities regulation. However, the mechanics of “control” are very weakly defined in the Lamfalussy process. It is submitted that in the absence of a sufficiently certain and sophisticated mechanism of control, the Lamfalussy process does not seem to amount to a system. Although CESR has taken off in its Level Three role, CESR’s governance will be considered separately. The original Lamfalussy process arguably does not provide for sufficient control in the *effector* stages of the system.

Next, one turns to the aspect of information-gathering that performs the feedback loop for cybernetic systems. Level Three of the Lamfalussy process provides for continuing

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<sup>3</sup>Iris H-Y Chiu, “On the Identification of an EU Legal Norm” (2007 forthcoming) Yearbook of European Law.

information-gathering. However, CESR's role of information-gathering at Level Three lacks any direct link to any regulatory outcome. This suggests that the information-gathering is either not used for a regulatory purpose, or lost in the process of regulatory translation. The former suggests the lack of a system in the Lamfalussy process, though the latter may suggest that the process is an imperfect system. Finally, Level Four measures intend to secure the compliance of Member States, but is a weak form of "control" to secure the cohesiveness of the system. This thesis will argue that the Lamfalussy process is not a system for directing regulatory convergence in EU securities regulation.

### *2.1 Institutional Status of the Lamfalussy Procedure*

The fast-track Lamfalussy procedure in law-making is intended to allow speedier enactment of securities regulation, so as to respond to industry and market needs. This procedure at first blush seems to be able to accommodate law reform in the future for new laws. However, is the Lamfalussy procedure intended to continue as an institution for law-making, in securities regulation and possibly in other areas such as banking,<sup>4</sup> or is it a measure of deviation from the usual law-making process in the EU and is not to be given institutional status?

If the Lamfalussy procedure were to be institutionalised as a law-making process, then the original context in which it arose, i.e. securities regulation, may not matter in its general application. The use of the Lamfalussy procedure has been recommended for banking sector

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<sup>4</sup> This was identified to be a possibility by the Inter-Institutional Monitoring Group (IIMG) on the use of the Lamfalussy Process. The Group carries out annual reports on the effects of the Lamfalussy Process and the progress of securities regulation in the EU. The third IIMG report issued in November 2004 indicated the possibility of extending the Lamfalussy process to banking and company law, but this is to be on a case by case basis. See IIMG report on the European Parliament website [http://europarl.eu.int/comms/internal\\_market](http://europarl.eu.int/comms/internal_market).

reforms, particularly in the implementation of the Basel II Capital Accord.<sup>5</sup> The long term implications of the Lamfalussy procedure are however not stated in the Lamfalussy report.

It could be argued that the Lamfalussy procedure has already become an institution as the European Securities Committee, which is intended to assist the Commission in adopting Level Two legislation, has already been formed, and the Committee of European Securities Regulators, which is in charge of preparing the groundwork for Level Two legislation, and consultation and cooperation under Level Three, has also been formed, and has its own secretariat, charter and consultation guidelines.<sup>6</sup> The existence of these supporting structures may provide some form of permanence for the Lamfalussy procedure.

One of the implications of the institutionalisation of the Lamfalussy procedure would be the institutionalisation of delegated legislation made by the European Commission (Level Two measures). However, it may be argued that a Level One/Two distinction in law-making responsibility, as provided for in the Lamfalussy process, requires the same justifications as those that legitimate delegated legislation in a nation state. The dominant justification for delegated legislation is that it is too burdensome for primary legislation to provide all the technical details, and delegated legislation made by the executive arm of the government can more effectively fill in the technical gaps in day-to-day exercise of policy-making.<sup>7</sup> Level Two law-making responsibilities undertaken by the Commission could be argued to perform a similar function.<sup>8</sup> Unfortunately, the analogy is not complete as delegated legislation can be reviewed in a national court, but the only control over the Commission's Level Two measures would be its adherence to the Stockholm Resolution and the Parliament's sunset

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<sup>5</sup> Speech by Jose Maria Rolden, Director-General of Regulation, Bank of Spain, in the HM Treasury seminar on "After the EU FSAP: A New Strategic Approach" (May 2004). See also EFC Report on Financial Regulation (9 Oct 2002), at [www.europa.eu.int/comm/internal\\_market/en/finances/cross-sector/consultation/efc-report\\_en.pdf](http://www.europa.eu.int/comm/internal_market/en/finances/cross-sector/consultation/efc-report_en.pdf).

<sup>6</sup> Michael McKee, "The Committee of European Securities Regulators: Is It Working?" (2002) 4 JIFM 111.

<sup>7</sup> Edward C. Page, *Governing By Numbers: Delegated Legislation and Everyday Policy-Making* (Oxford: Hart 2001).

<sup>8</sup> Rosa M. Lastra, "The Governance Structure for Financial Regulation and Supervision in Europe" (2003) 10 *Columbia Journal of European Law* 49.

clause.<sup>9</sup> Thus, perhaps one should be more cautious in arguing that the Level One/Two procedure has institutionalised a form of delegated legislation-making. The sunset clause in particular highlights the possibility that Level Two delegated legislation is a merely temporary and functional phenomenon.

On the other hand, the draft EU Constitution may arguably support the permanence of the Lamfalussy process. The Constitution sets out what the EU's legislative and non-legislative acts are.<sup>10</sup> Non-legislative acts include delegated legislation and thus, there seems to be recognition for the Commission making delegated legislation when the primary laws so authorise.<sup>11</sup> However, although recognition is given to delegated legislation as non-binding legislative acts that could be initiated by the Commission, the conditions under which non-legislative acts may be instituted are very restricted, and delegated legislation to the Commission is one such instance. Article 35 of the draft Constitution limits the ambit of delegated legislation to non-essential aspects of the primary law and such aspects have to be specifically identified in the primary law. Thus, Level Two measures carried out by the Commission would only serve the specific identified purposes set out in the primary legislation and thus, this is narrower than delegated legislation available to national agencies. Once spent, the power to make Level Two measures does not seem to be a revolving one. Using the cybernetic model of analysis, Level Two has apparently a norm-setting function. However, it is not likely to amount to norm-setting in the cybernetic sense, as the continuity inherent in a cybernetic system, where information gathering may feedback into the system and cause modification of the norms, is missing. Level Two powers are not permanent in nature. Although the Directives provide for future reviews of the securities laws,<sup>12</sup> such

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<sup>9</sup> See n49 and Part 2.4.3 of chapter 2.

<sup>10</sup> Article 32ff, of the draft Treaty establishing a Constitution, 18 July 2003, text can be found on [http://european-convention.eu.int/doc\\_register.asp?lang=EN&Content=DOC](http://european-convention.eu.int/doc_register.asp?lang=EN&Content=DOC), accessed March 2005.

<sup>11</sup> Article 35 of the draft Treaty establishing a Constitution, 18 July 2003.

<sup>12</sup> For example, Article 65, MIFID, and Article 33, Transparency Directive.

reviews may not result in the use of the same Lamfalussy procedure to reform the laws. There is arguably no entrenchment of the Lamfalussy procedure as such in the Directives.

It has been argued that it is best to view the Lamfalussy process merely as a useful process so that it could be fine-tuned like any other models in the future, and could be superseded in future reviews.<sup>13</sup> Furthermore, the process seems to have a linear timeline. In the current round of reforms, the securities directives have all gone through Level One of the Lamfalussy procedure, but Level Two measures are not all complete and a full cycle of the procedure up to Level Three has not been completed as implementation in Member States takes time. Thus, it could be argued that the four levels are linear, and the Levels when completed, would be spent.

It may be argued that the linear procedural framework for law-making under the Lamfalussy report is contrary to an institutionalised revolving process of law-making. Level One measures are comprehensive and packed with details,<sup>14</sup> and Level Two measures generally elaborate on specific areas of mandate spelt out in Level One. Level Two is subordinate to and takes place after Level One, and is not a continuous process for law-making.<sup>15</sup> Although the Prospectus Regulation and MIFID Commission Regulation manifest the power of delegated legislation in the hands of the Commission, these measures are highly technical and specific, and the Commission has no inherent power to modify the Regulations once made.

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<sup>13</sup> M McKee, "The Unpredictable Future of European Securities Regulation- A Response to 4 Predictions About the Future of EU Securities Regulation by Gerard Hertig and Ruben Lee" (2003) 18 JIBLR 277 suggests that the Lamfalussy procedure should be regarded only as a process and not as an institution, and may be liable to be amended as time goes by.

<sup>14</sup> N Moloney, "The Lamfalussy Legislative Model" (2003) 52 ICLQ 499, and Burcak Inel, "Assessing the First Two Years of the New Regulatory Framework for Financial Markets in Europe" (2003) 18 JIBLR 363. This is also the view of the IIMG in their third report of November 2004, *op cit* at n4.

<sup>15</sup> This may be in line with the European Court's cautious approach to the interpretation of incidental powers of delegated functions, see Case 25/70 *Einfuhr- und Vorratsstelle für Getreide und Futtermittel v Köster et Berodt & Co*, [1970] ECR 1161. See also discussion in YV Avgerinos, "Essential and Non-essential Measures: Delegation of Powers in EU Securities Regulation" (2002) 8 ELJ 269.



If Level Two measures were instituted as a mechanism for producing continuous delegated legislation, then Level Two measures would arguably be able to tweak or modify the effects of norms set at Level One, upon feedback received within the cybernetic system. The dis-empowerment of Level Two measures means that Level Two measures cannot perform a revolving process of change and modification for Level One, further supporting the argument that Levels One and Two are one-off processes for law-making that have no further institutionalised status. One further problem identified by the Inter-Institutional Monitoring Group<sup>16</sup> for the Lamfalussy Process and Securities Regulation is that, due to the amount of time taken for law-making in the EU, Levels One and Two may actually proceed at the same time, and thus, there is even less prospect of Level Two measures performing a feedback and *modification* function within the cybernetic system. Level Two may merely be the technical counterpart to Level One in setting norms at the same time.

Furthermore, at the current post-FSAP phase, it has been reiterated<sup>17</sup> that there should be legislative respite as so many measures have already been rolled out in the new Directives. Thus, there is no particular desire on the part of Member States to seek recourse to law reform for financial markets in the short to medium term. Hence, there is unlikely to be political support for institutionalising the Lamfalussy process.<sup>18</sup>

Levels One and Two seem to be one-off processes whereby a large volume of new securities laws are provided, and do not constitute a continuing framework of regulation and law reform. Even though Levels One and Two provide the norms for the new securities laws, the arguable lack of institutionalisation of these Levels means that these processes are unlikely to be permanent or revolving. A cybernetic system of regulation is a continuous and revolving one,

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<sup>16</sup> IIMG 3<sup>rd</sup> Report, Nov 2004.

<sup>17</sup> Charlie McCreevy, Commissioner for the Internal Market's remarks at the inaugural CESR conference, Paris, 6 Dec 2004.

<sup>18</sup> Speech by James Bloomer, HM Treasury seminar (May 2004). See also Peter Norman and Tobias Buck, "Europe to Slow the Pace of Financial Services Reform" in the *Financial Times* (17 January 2005).

allowing information gathering and feedback to modify norms or *effectors*' behaviour. Thus, it seems that the Lamfalussy procedure may not amount to a cybernetic system for EU securities regulation.

## *2.2 Multiversalism in the System*

Although the law-making aspects of the Lamfalussy procedure do not quite suffice for the norm-setting paradigm of a cybernetic system, it could be argued that the norms of the EU securities regulation system are set by the community method, and therefore, the EU securities regulation system is just a subset of a well-established EU regulation system.

However, as discussed,<sup>19</sup> national transposition of the Directives gives rise to many sets of national laws emanating from the primary EU Directive, producing “multiversal” norms of the same subject matter. Multiversalism brings about the fundamental problem of a multitude of *selectors* in the cybernetic analysis. Although the EU law-making procedure is well-institutionalised, the existing system does not of itself secure regulatory convergence.

## *2.3 CESR's role in Information-Gathering and the Feedback Loop*

Level Three of the Lamfalussy procedure provides for CESR's role in assisting and monitoring national implementation of the securities laws. Could it be argued that, as Level Three provides for information-gathering in order to feedback into the system, thus, together with Levels One and Two, the Lamfalussy procedure may have some features of a cybernetic system after all? At Level Three, CESR is responsible for information-gathering and is expected to periodically conduct peer reviews of national regulation and regulatory practices

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<sup>19</sup> Part 2.2 of chapter 2.

in Member States, and report their results to the Commission and ESC.<sup>20</sup> In a cybernetic model, the information-gathering is for the purpose of feeding back into the system to allow for modification of norms or *effector* behaviour. The information gathered affects the effectiveness and responsiveness of the system.<sup>21</sup>

Information-gathering is performed by the regularisation of CESR meetings every quarter, and by the establishment of a permanent CESR secretariat to deal with the administrative matters of information-gathering. The secretariat regularly invites public consultation on selected matters, organises expert groups to study particular issues, and has set up a Markets Consultants Review Panel to monitor national implementation, and to understand the needs of the industry and market.<sup>22</sup> Thus, information-gathering is done in a systematic way. CESR also sets up specific groups to gather information on the status of regulatory convergence, such as the Market Abuse Review Panel and Prospectus Groups, and CESR-Pol and CESR-Fin, which gather information on supervisory and enforcement differences in respect of the different Directives. The information gathered by CESR is reported largely to the European Commission, and would usually be published on CESR's website as well. However, CESR's reviews may not directly influence regulatory outcomes. This is because the Level Three role of information-gathering is not supported by any form of translation into regulatory input. In a cybernetic model, information that is gathered should have a "report" aspect as well as a "command" aspect, to direct future changes.<sup>23</sup> But the European Commission does not have to explain whether it adopts or rejects CESR's views. Further, although the information would be known to all national regulators, there is no necessity that national regulators would use this information to modify their own behaviours.<sup>24</sup>

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<sup>20</sup> Lamfalussy report at 37.

<sup>21</sup> Cary Coglianese, Richard Zeckhauser and Edward Parson, "Seeking Truth for Power: Informational Strategy and Regulatory Policy-making" (2004) 89 Minnesota Law Review 277.

<sup>22</sup> at [www.cesr-eu.org](http://www.cesr-eu.org).

<sup>23</sup> Rejean Landry and Vincent Lemieux, "L'analyse cybernetique des politiques gouvernementales" (1978) 11(3) Canadian Journal of Political Science 529.

<sup>24</sup> This is discussed in the three aspects of regulatory convergence discussed in chapter 3.

Further, there is no mechanism to systematically feed CESR's gathered information to the Commission in order to affect the modification of regulatory output. Level Three of the Lamfalussy process allows the Commission to refer to CESR to undertake various groundwork in terms of consultation and information-gathering, thereafter reporting results to the Commission, but it does not provide for CESR's own initiative to communicate information to the Commission. This does not bar the possibility of non-formal or non-institutionalised forms of communication between CESR and Commission officials. However, the lack of formalising CESR-initiated communication to the Commission may indicate the weakness of its information-gathering role, and it is uncertain to what extent the information would be fed back into or used for modification effects within the system.

In sum, although the information-gathering aspect of CESR allows CESR to perform a necessary part of the cybernetic regulation system, the uncertainty in how the information is used weakens the information-gathering role, and undermines support for the possibility that the Lamfalussy procedure as a whole amounts to a regulatory system for EU securities regulation.

#### *2.4 Level Four Measures*

Finally, under the Lamfalussy process, it is possible to use Level Four measures against errant Member States to compel them to implement the Directives and Commission legislation. Level Four measures are intended to perform the cybernetic role of securing compliance among Member States. However, as a form of "control", Level Four is arguably weak. As discussed in Part 2.4.4 of chapter 2, Level Four measures are taken from the general mechanism for enforcement against non-implementation, found under Article 226 of the Treaty of Rome. Article 226 deals with Member States' general compliance with EU

legislation, and is thus part of the landscape of general EU governance and not specific to securities regulation as such. It would be expected that for the purposes of regulatory convergence, the methodology of “control” would likely be more severe than it would be under general EU regulation, and hence, falling back upon general EU regulatory methodology is not highly satisfactory for securing compliance in the cybernetic sense. Enforcement under Article 226 is likely to deal with non-implementation, and not issues of convergence. There is arguably no enforcement mechanism to judge the level of convergence amongst Member States as such.<sup>25</sup>

Level Four is also not a practical method in securing compliance by Member States themselves as the enforcement process would take too long<sup>26</sup> for businesses and market players to benefit from the enforcement.<sup>27</sup> In the meantime, the negative effects on the Internal Market following from regulatory fragmentation would continue pending the European Court making a decision.<sup>28</sup>

However, it may be argued that complemented by state liability for failure to implement community law, Level Four could be effective as a form of “control”. It is possible for individuals to take action against errant Member States for failing to transpose Directives. As has been shown in the case of *Francovich v Italy*<sup>29</sup>, state liability may be incurred towards the

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<sup>25</sup> See Part 2.4.5 of chapter 2.

<sup>26</sup> Rodolphe Munoz has written extensively on how Article 226 may be streamlined to be more efficient and quicker and that it would only be effective if flanked by other measures, in “The Monitoring of the Application of Community Law: The Need to Improve the Current Tools and an Obligation to Innovate” Jean Monnet Working Paper 04/06, 2006, available at <http://www.jeanmonnetprogram.org/papers/> (accessed Oct 2006).

<sup>27</sup> George Wittich, “Implementing the Lamfalussy Report: The Contribution of Europe’s Securities Regulators” (2001) 3(6) JIFM 209. See also S Weatherill, “Reflections on EC law’s “Implementation Imbalance” in the Light of the Ruling in *Hedley Lomas*” in L Kramer, H-W Micklitz and K Tonner (eds), *Law and Diffuse Interests in the European Legal Order* (Baden-Baden, VIEW/Nomos 1997); S Weatherill, “Addressing problems of imbalanced implementation in EC law: Remedies in an Institutional Perspective”, in C Kilpatrick, T Novitz and P Skidmore (eds), *The Future of Remedies in Europe* (Oxford, Hart 2000) and S Weatherill, “Pre-emption, Harmonisation and the Distribution of Competence to Regulate the Internal Market” in C Barnard and J Scott (eds), *The Law of the Single European Market* (Oxford: Hart 2002).

<sup>28</sup> R Munoz, “Development of Ex Ante Control” in T Tridimas and P Nebbia (eds), *EU Law* (Oxford: Hart 2004).

<sup>29</sup> Cases C-6/90 & C-9/90, 1991 ECR. I-5357.

individual for losses ensued upon non implementation of community Directives, and thus, Level Four measures may be supplemented by individual actions as such. The Inter-Institutional Monitoring Group also mentions in its 2004 report, that Level Four measures should be strengthened for individual actions in order to secure the successful implementation of the Directives and Level Two legislation. One commentator has also said that *Francovich* type decisions from the European Court could act as a compelling force for Member States to converge in their implementation of Directives, reducing variations and fragmentation for fear of state liability.<sup>30</sup>

In securing compliance, Julia Black has argued that

“This is the real heart of the regulatory function: how to alter behaviour so that people act in the way that they would not otherwise do, and in such a way as to ensure that the objectives of the regulatory system are met.”<sup>31</sup>

Article 226 proceedings and state liability incurred under individual actions may compel a change in Member State behaviour. However, Article 226 and *Francovich* type actions may penalise Member States for non-implementation and not for regulatory divergence. Level Four does not deal with securing compliance with respect to convergence as such.

In sum, the Lamfalussy procedure lacks the norm-setting, information feedback and systematic modification features that are present in a cybernetic system, and does not provide sufficiently for securing compliance by Member States to adopt regulatory convergence. It arguably does not sufficiently amount to a system at the EU level for regulatory convergence

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<sup>30</sup> Edward T Swaine, “Subsidiarity and Self-Interest: Federalism at the European Court of Justice” (2000) 41 Harvard International Law Journal 1. He criticised the *Francovich* decision as having imposed state liability without a sound foundational understanding of the role of subsidiarity. He advocates a narrow view of subsidiarity confined to Treaty specified competences, and to be based on satisfaction of the cross-border effects and enhanced effectiveness tests. He also advocates that the ECJ should itself be subject to a judicial subsidiarity test in order to determine its jurisdiction and scope of remedial powers so that any issue of state liability may be founded upon a surer footing.

<sup>31</sup> Black “Enrolling Actors” (2003), op cit at n2.

on a *continuous* basis. The chapter turns now to CESR's governance to examine if CESR's governance provides the EU level system that is needed to secure regulatory convergence.

### 3. CESR's Governance as a Regulatory System for EU Securities Regulation?

It will be argued that CESR's work is more to be regarded as a form of *governance*<sup>32</sup> without *regulatory control* over its domain of influence, i.e. the Member State regulators.<sup>33</sup>

Governance as defined by the Commission's White Paper on EU Governance<sup>34</sup> means "rules, processes and behaviour that affect the way in which powers are exercised at European level, particularly as regards openness, participation, accountability, effectiveness and coherence".

Governance is a concept that encompasses mechanisms, processes and potential to influence the actual exercise of power and provision of outcomes. Governance can thus be by institutions, institutions using law, regulation itself or other forms of mechanisms that allow institutions to exercise power,<sup>35</sup> without necessarily being endowed with formal authority.<sup>36</sup>

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<sup>32</sup> Governance takes on the meaning of influence upon the ultimate policy outcome, being a factor that shapes decisional policy, and is a concept that is not necessarily translated into direct legal effect such as regulation. An example of governance at work is described in Claus J Schultze, "Cities and EU Governance: Policy-Takers or Policy-Makers?" (2003) 13(1) *Regional and Federal Studies* 121.

<sup>33</sup> "Regulation" means a sustained and focused approach to modifying the behaviour of subjects of the regulation, in order to secure compliance with regulatory standards and goals, see K Yeung, *Securing Compliance* (Oxford: Hart 2004) at 5.

<sup>34</sup> COM 2001/428 final.

<sup>35</sup> "Governance" may mean governments interacting with other influences producing a governing process in total. This is at least one of the earlier understandings of governance, as political scientists' realise that governments do not have exclusive say over ordering and governing in an internationally inter-dependent environment. See William W Boyer, "Political Science in the 21<sup>st</sup> Century- From Government to Governance" (1990) 23 *Political Science and Politics* 50. Later writings describe governance as the processes and mechanisms through which power may be exercised in order to produce a certain ordering of matters, so as not to fall into anarchy. In relation to international governance, see Elizabeth Zoller, "Institutional Aspects of International Governance" (1995) 3 *Indiana Journal of Global Legal Studies* 121. It is arguable whether governance can exist outside of institutional frameworks, institutions being defined as "persistent sets of rules that constrain activity, shape expectations and prescribe roles" (Robert D Keohane, *International Institutions and State Power* (Boulder: Westview Press 1989). Lewis Kornhauser defines governance as the function of institutions to resolve social problems of adaptation, application of norms, adjudication and sanction, and law is a means of such governance. See "Governance Structures, Legal Systems and the Concept of Law" (2004) 79 *Chicago-Kent Law Review* 355. Governance employing law as a process is also critically discussed in Kerry Rittich, "Enchantments of Reason/Coercions of Law" (2003) 57 *University of Miami Law Review* 727.

<sup>36</sup> James N. Rosenau, "Governance, Order and Change in World Politics" in James N Rosenau and Ernst-Otto Czempiel (eds), *Governance Without Government* (1992, 2000 Reprint, Cambridge: CUP) at 5.

Thus, governance is broader concept than regulation,<sup>37</sup> which is a governance process using law in a sustained and focused way to prescribe, constrain, define or sanction against activity. It would be argued that CESR's role is a form of *governance* without the power of *regulation*.<sup>38</sup>

Using a cybernetic model of analysis, a cybernetic regulatory system needs to set its own norms, maintain control over the execution of the norms, gather information regarding the execution of the norms for feedback purposes, and secure compliance with the norms (in this context, as discussed, the compliance to be secured is that of national regulators). CESR's governance will be examined in these respects.

### *3.1 Norm-Setting by CESR*

As discussed in Part 2.4.4 of chapter 2, CESR's guidelines and standards produced to assist interpretive convergence are likely regarded as soft law. Although there may be increasing recognition in international and European governance as to the importance of soft law, soft law lacks up-front "binding quality" which can secure control over compliance by Member States in national transposition.

As discussed in chapters 2 and 3, although CESR's governance output does not arguably have a binding quality, the forces of regime interaction and consociational forces<sup>39</sup> within CESR may persuade CESR members to adopt convergent positions over time by stealth.

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<sup>37</sup> Some commentators may equate governance with a modern form of post-state government, so that governance would include the entire capacity to govern, including by regulation, see K Armstrong, "Governance and the Single European Market" in Paul Craig and Gráinne de Búrca (eds), *The Evolution of EU Law* (Oxford: Oxford University Press 1999) at 745.

<sup>38</sup> One commentator has opined that governance includes "network" operations that produce regulatory convergence, although there is no regulatory function *per se* in such governance. See Daniel K Tarullo, "Law and Governance in a Global Economy" (1999) 93 American Society of International Legal Proceedings 105. Network operations that produce soft law would also generally be regarded as "governance", see Kenneth Armstrong and Simon Bulmer, *The Governance of the Single European Market* (Manchester: Manchester University Press 1998) at 256.

<sup>39</sup> To be discussed in Part 3.1, chapter 5.



However, such a form of governance by CESR is likely to be more pluralistic and fluid in nature, and does not arguably amount to a cybernetic regulatory system.

The key problem in CESR's governance is that it is unable to *regulate* the securities industry and markets directly, or its member regulators who would be administering the actual regulation. CESR's norms relate to Member States, and apart from the recent recommendations on market data reporting which may be viewed as being addressed to the securities markets,<sup>40</sup> CESR's soft law do not relate directly to the regulated. Even if the recommendations on market data reporting may be seen as addressing securities markets and providing guidelines on how market data is to be reported, this is an indirect form of admonition which can be ignored by the markets, as markets are only obliged to their home regulators.<sup>41</sup> Furthermore, Member States are, under the multiversalism phenomenon, norm-setters themselves. As such, Member States are able to choose whether to align with CESR's norms or otherwise. The prospect of alignment depends on the regime forces and consociational influences working within CESR. The prospects of divergence will be discussed in chapter 5. Hence, CESR may ultimately be an arrangement to manage the political relations between regulators, and this form of governance does not amount to regulation.

### *3.2 Information Gathering and Feedback within CESR's System*

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<sup>40</sup> CESR, *Publication and Consolidation of MIFID Transparency Data* (Feb 2007), available at [http://www.cesr-eu.org/index.php?page=document\\_details&from\\_title=Documents&id=4228](http://www.cesr-eu.org/index.php?page=document_details&from_title=Documents&id=4228).

<sup>41</sup> Home regulators currently take different approaches to regulating market data transparency. In the UK, the Financial Services Authority (FSA) recognises several primary information providers to collect regulatory information and provide them free of charge to users. As the number of primary providers is limited, users can be directed to a few sources for information, and this achieves a type of consolidation of access. See Financial Services Authority, *Review of the UK Mechanism for Disseminating Regulatory Information by Listed Companies* (London: FSA, Consultation Paper 92, 2001) and FSA, *Proposed Changes to the UK Mechanism for Disseminating Regulatory Information by Listed Companies* (London: FSA Policy Statement, November 2001). See E Ferran, *Building an EU Securities Market* (Cambridge: Cambridge University Press 2004) at 193ff. In Germany, market data is provided by the securities markets themselves, and there is no regulatory framework for consolidation or ensuring access.

Information collection is a strong point with CESR as there are various mechanisms set up for that purpose.

First, CESR has devoted itself to monitoring national implementation by setting up Review Panels for different issues.<sup>42</sup> The Review Panels however monitor implementation progress in Member States by collecting information on questionnaires. The Panels use a “check and trust” approach and accepts answers on questionnaires<sup>43</sup> as conclusive of implementation progress. CESR does not seem to critically examine the implementing measures for convergence and accepts implementation as a successful outcome. This is probably the weakest area of CESR’s work as this approach is not very different from the traditional national transposition process, which is based on “results” implementation.<sup>44</sup> Although CESR is expanding the work of the Review Panels into judging the “level of convergence” achieved, this is as yet in its early stages, and benchmarks for convergence have to be determined. Thus, the current information that is collected may be too general and not useful enough to indicate levels of convergence.

As mentioned earlier, CESR gathers information in a systematic way, but the information does not feed directly into regulatory input. Under the Lamfalussy process, CESR’s information is crucial to the designation of Level Two measures, but once Level Two measures are spent, CESR’s information gathering role may not be able to feed into future law reform. In a cybernetic model, information that is gathered should have a continuous and looping “report” aspect that shapes future changes.<sup>45</sup> However, there is also no institutionalised procedure for CESR to make recommendations to the Commission based on

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<sup>42</sup> CESR Himalaya Report 25 Oct 2004, at [www.cesr-eu.org](http://www.cesr-eu.org).

<sup>43</sup> CESR’s implementation review guide, published in April 2005, Ref CESR 04-711b, is available on the web at [www.cesr-eu.org](http://www.cesr-eu.org).

<sup>44</sup> The general implementation outlook in the EU is not looking good either, see the Commission 2<sup>nd</sup> Implementation Report of the Internal Market Strategy 2003-6, COM (2005)final, at the European Parliament website for the Internal Market, at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:%2052005DC0011:EN:NOT>.

<sup>45</sup> Landry and Lemieux (1978) op cit at n23.

the information it has gathered on a revolving basis. The European Commission also need not adopt CESR's views and need not explain the adoption or rejection of CESR's views. In terms of influencing national regulators to change aspects of their *regulation*, CESR's information may provide a uniform platform for regulators in identifying issues and challenges, but how that information translates into individual regulators' decisions will depend on regime and consociational influences in CESR. Thus, the essential breakdown in the link between CESR's information gathering and regulatory functions carried out by other national or EU institutions limits CESR's role to a form of governance without regulation. CESR's role is unlikely to amount to a cybernetic system at the EU level for EU securities regulation.

### 3.3 Securing Compliance

As discussed in Part 3.3 of chapter 3, CESR resembles a *regime* which is a network of participants that may provide influence over an issue area. Regimes exist by securing assent amongst their members and depending on the political clout of any particular member or members, there may not be any predictable manner of imposing agendas or rules vertically upon other members of the regime. Thus, regimes by nature do not arguably "secure compliance" in an institutionalised manner. If assent is achieved within the regime, it may be due to common goals and objectives, or political clout exercised by members.

Positivist theories often regard law as inextricably bound with sanctions.<sup>46</sup> This is because sanctions provide the obligatory nature that is inherent in law. The argument therefore goes that law is law because it is capable of sanctioning. In CESR's case, it is already discussed

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<sup>46</sup> See John Austin, *The Province of Jurisprudence Determined* (Cambridge: Cambridge University Press Rep 1995), and discussion on Austin's theory, M.D.A. Freeman, *Lloyd's Introduction to Jurisprudence* (London: Sweet & Maxwell 1994) at 222; Hans Kelsen, *General Theory of Law and State* (Transl by Anders Wedberg), (Mass: Harvard University Press 1946) at 18-19, 45-7.

that CESR's guidelines and standards are at best soft law, which has no formal binding status. As soft law *prima facie* cannot be capable of sanctioning, there is doubt that CESR's output is law. Even where one applies Hart's theory of the law as norms recognised by a rule of recognition,<sup>47</sup> the lack of a rule of recognition recognising CESR's soft law as law would disqualify such soft law from being a primary norm.<sup>48</sup> In Hart's theory, the enforcement of primary norms belongs to the realm of secondary norms, all validated by the rule of recognition. As soft law may not be regarded as a primary norm, secondary norms for enforcement do not come into play. Thus, CESR is theoretically not able to secure compliance, in the absence of its soft law being recognised as law in the first place.

CESR's institution of the peer mediation procedure discussed in Part 3.3 of chapter 3 intends to provide a mechanism that approximates to securing control over its member regulators. It has been suggested that CESR could act as a "Supervisor of Supervisors."<sup>49</sup> As discussed in chapter 3, CESR's mediation mechanism or database of enforcement decisions are mechanisms of influence, and even if such mechanisms, working in tandem with regime and consociational forces within the regime, may be able to provide convergence by stealth, the nature of fluid persuasion does not amount to a cybernetic regulatory system to secure the compliance of regulators. CESR's role is one that is a form of governance at best, without being able to regulate the regulators or the subjects of the regulation directly.

In sum, CESR does not have a regulatory relationship with the subjects of regulation, and does not have powers of regulation over its member regulators. By examining CESR's governance in a cybernetic model of analysis, its arrangements amount to a form of *governance sans regulation* over its members. Its governance is persuasive in nature and does

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<sup>47</sup> H.L.A. Hart, *The Concept of Law* (Oxford: Clarendon, 1961 Rep 1994) at 79-110.

<sup>48</sup> See Part 2.4.4, chapter 2.

<sup>49</sup> The third IIMG report issued in November 2004, available at [http://europa.eu.int/comm/internal\\_market/securities/monitoring/index\\_en.htm](http://europa.eu.int/comm/internal_market/securities/monitoring/index_en.htm).

not arguably secure control over its member regulators in any institutionalised or systematic way. Thus, CESR's governance cannot at the moment be regarded as an EU level system for EU securities regulation.

#### 4. Conclusion

This chapter has attempted to evaluate whether, in the absence of an EU agency for securities regulation, there is an EU system of securities regulation in either the Lamfalussy procedure, or CESR's governance. It is suggested that the Lamfalussy procedure does not amount to a regulatory system for EU securities regulation, as although it provides norm-setting, the norm-setting function does not appear to be persistent for the future. Enforcement in Level Four measures is also arguably weak where the threshold of convergence is concerned.

It is further suggested that CESR also does not provide a regulatory system for EU securities regulation. CESR's influence over EU securities regulation is more akin to a form of *governance sans regulation* over its members. In the absence of the Lamfalussy procedure or CESR's processes amounting to a system for EU securities regulation, any system for EU securities regulation may have to be discerned in general law-making and EU governance. As discussed, the use of Directives resulting in multiversal national transpositions produces a sum aggregate of 25 national securities regulation systems, and not necessarily an EU regulatory system as a whole. This is recognised by the Commission in its Green Paper<sup>50</sup> where the idea of having a 26<sup>th</sup> regime for "EU securities regulation" apart from the 25 regimes of national securities regulation in the EU, was mooted.

This thesis suggests that in the absence of an EU level system for EU securities regulation, and in the absence of cybernetic features in the four aspects of regulatory convergence,

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<sup>50</sup> Green Paper on Financial Services Policy 2005-2010, COM(2005)177.

**national divergences are likely to subsist in the future of EU securities regulation. Chapter 5 discusses the areas of substantive law where such divergences are likely to occur and the incentives for such divergences. Chapter 6 then examines what may really be needed to secure a cybernetic system of regulatory convergence in EU securities regulation.**

## **Chapter 5**

### **Regulatory Divergences amongst Member States**

#### **1. Introduction**

The thesis has thus far discussed the challenges to developing regulatory convergence in EU securities regulation. Chapter 2 discusses the concept of regulatory convergence and introduces the use of the cybernetic model of analysis to examine whether the current framework in EU securities regulation has sufficient cybernetic features to achieve regulatory convergence. Chapters 2 and 3 evaluate the mechanics for regulatory convergence in the sources of law, interpretation and administration, supervision and enforcement, and suggest that, applying a cybernetic model of analysis, it is unlikely that convergence may be *secured*. However, it is arguable that convergence may be achieved through longer term regime forces and persuasion within CESR. Chapter 4 then examines if there is an EU level system for EU securities regulation. It is argued that neither the Lamfalussy process nor CESR's governance is sufficient to amount to a cybernetic regulatory system for EU securities regulation.

This chapter will discuss the forces driving divergence amongst Member States. This chapter will also discuss the role of EU institutions such as the Commission and the Court to examine the extent of their influence over potential diverging forces.

#### **2. Forces for Divergence in EU Securities Regulation**

In the absence of a cybernetic system to ensure regulatory convergence, securities regulation in the EU is an aggregate of national securities regulation and CESR's *governance*.

Organisation theory may be used to show that where there is fragmentation and decentralisation in the execution of an objective, conflicting individual interests will develop to impede the attainment of the objective, unless such fragmentation and conflict can be contained and controlled within an overall system whose coherent values will prevail. Selznick, an eminent functional sociologist, studied the issue of “delegation” within organisations, and his findings may be useful for analogical consideration of the decentralised network of securities regulation in the EU. Selznick<sup>1</sup> opined that delegation led to increasing bifurcation of interests in an organisation, and such bifurcation would likely result in conflict amongst different units of the organisation. This may be mitigated if the overall goals of the organisation are coherent, and “ideology and co-option” can be used to keep the organisation coherent and focused.<sup>2</sup>

Applying this by analogy to the current state of EU securities regulation, EU securities regulation is a decentralised network of national securities regulation, and CESR’s *governance*. Thus, individual interests of Member States may conflict and diverge. Such divergences may be controlled and constrained if an overall framework of the network is coherent and focused. However, as discussed, there is an overall lack of a regulatory *system* in EU securities regulation at the EU level, and all four aspects of regulatory convergence may not be systematically *secured* under the current framework, although there may be a prospect for convergence by stealth. Hence, this chapter turns to look at the possibility that individual interests and conflicts may ensue in due course to result in the gradual divergence of national securities regulation.

### ***Incentives to Diverge***

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<sup>1</sup> P Selznick, “An Approach to a Theory of Bureaucracy” (1943) 8 *American Sociological Review* 47, also, “Foundations of the Theory of Organisation” (1948) 13 *American Sociological Review* 25.

<sup>2</sup> A succinct discussion of Selznick may be found in John Hassard, *Sociological and Organisational Theory* (Cambridge: Cambridge University Press 1993) at 28ff.



In the absence of a top-down regulatory system for EU securities regulation to control and direct towards regulatory convergence, it may be possible that convergence can be achieved through coincidental bottom-up efforts, i.e. that national interests are coincidentally aligned to take the convergent direction. This is not an impossible phenomenon, as much of “international convergence” in international securities regulation has arisen from bottom-up efforts.<sup>3</sup> In international securities regulation, capital mobility is desired by large international securities players. Cross-border issues of supervision and enforcement, as well as the necessity in achieving an even standard of investor protection, have prompted national regulators to form a voluntary organisation<sup>4</sup> to look at standardising various aspects of securities regulation.<sup>5</sup> One of the main achievements of the International Organisation of Securities Commissioners (“IOSCO”) is the recommendation of convergence in disclosure standards required in cross-border capital issues<sup>6</sup> in 1998. These standards have been adopted by many significant jurisdictions such as the United States, for foreign issuers, and have been adopted by the EU in the current round of securities reforms, as well as other jurisdictions

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<sup>3</sup> Dimity Kingsford Smith, “Networks, Norms and the Nation State: Thoughts on Pluralism and Globalised Securities Regulation” in Catherine Dauvergne (ed), *Jurisprudence for an Interconnected Globe* (London: Ashgate 2003) where the role of IOSCO as a source of soft law is discussed, as a prospective force for international convergence. However, another eminent commentator opines that convergence cannot be achieved without the use of law. See Joseph J Norton, “Pondering the Parameters of the “New International Financial Architecture”: A Legal Perspective” in Rosa M Lastra (ed), *The Reform of the International Financial Architecture* (London: Kluwer 2000). See also Joseph J Norton, “International Financial Law”- An Increasingly Important Component of “International Economic Law”- A Tribute to Prof John H Jackson” (1999) 20 Michigan Journal of International Law 133.

<sup>4</sup> The International Organisation of Securities Commissioners (IOSCO), see <http://www.iosco.org>.

<sup>5</sup> Troy L Harder, “Searching for a Level Playing Field- The Internationalisation of US Securities Disclosure Rules” (2002) 24 Houston Journal of International Law 345. The benefits of convergence are also discussed in Marc I. Steinberg and Lee E. Michaels, “Disclosure in Global Securities Offerings” (1999) 20 Michigan Journal Of International Law 207 and Uri Geiger, “The Case for the Harmonisation of Securities Disclosure Rules in the Global Market” (1997) 1997 Columbia Business Law Review 241.

<sup>6</sup> IOSCO, *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers*, (Sep 1998), available at <http://www.iosco.org/library/index.cfm?section=pubdocs&year=1998> (accessed 25 Nov 2005).

such as Singapore, Mexico and France.<sup>7</sup> However, the bottom-up efforts at international level are still far from achieving international convergence.<sup>8</sup>

In order to inspire regulatory convergence from the bottom-up, EU level regulation may be in sync with national political interests,<sup>9</sup> or it may be such a model of excellent regulation that national regulation naturally converges with it.<sup>10</sup>

The study of national interests is beyond the scope of this thesis and is the subject of much study in the area of Europeanisation.<sup>11</sup> However, it is predicted that national economic

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<sup>7</sup> A detailed survey of the national implementation of IOSCO standards was carried out in Samuel Wolff, "Implementation of International Disclosure Standards" (2001) 22 *University of Pennsylvania Journal of International Economic Law* 91. This survey however is out of date as it did not include the new EU Directives.

<sup>8</sup> Some of the issues that run counter to international convergence such as domestic issues and regulatory competition are discussed in Amir Licht, "International Diversity in Securities Regulation: Roadblocks on the Way to Convergence" (1998) 20 *Cardozo Law Review* 227, Howell E. Jackson, "Centralisation, Competition and Privatisation in Financial Regulation" (2001) 2 *Theoretical Inquiries in the Law* 649. Contextual factors affecting convergence in securities regulation are discussed in John C. Coffee, "The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications" (1999) 93 *Northwestern University Law Review* 641. Prof Coffee also opines that social norms that underlie corporate culture may affect international convergence. See Coffee, "Do Norms Matter?" (2001) *University of Pennsylvania Law Review* 2151. Other contexts that may affect convergence include whether the financial and corporate culture of a jurisdiction allows a super-regulator for financial services to be formed. See Rolf H Weber, "Challenges for the New Financial Architecture" (2001) 31 *Hong Kong Law Journal* 241; Jerry W Markham, "Super-Regulator: A Comparative Analysis of the Securities and Derivatives Regulation in the US, UK and Japan" (2003) 28 *Brooklyn Journal Of International Law* 319. Domestic factors are important for national securities regulators to retain flexibility to cater to issuers or investors who are likely only to be domestic in nature, see Irina Shriniyan, "The Perspective of US Securities Disclosure and The Process of Globalisation" (2004) 2 *DePaul Business and Commercial Law Journal* 515 and Kun Young Chang, "Reforming US Securities Disclosure Rules in Global Securities Markets" (2003) 22 *Annual Review of Banking and Financial Law* 237. National institutions also tend to be path dependent in maintaining their own regulatory regimes, as they have domestic interests or their own interests to serve (under the theory of public choice). See Mark J. Roe, "Chaos and Evolution in Law and Economics" (1996) 109 *Harvard.LR* 641; Lucian A. Bebchuk & Mark J. Roe, "A Theory of Path Dependence in Corporate Governance and Ownership" (1999) 52 *Stanford Law Review* 127. The dynamics between states may also influence convergence or otherwise, see Amir Licht, "Games Commissions Play: 2x2 Games of International Securities Regulation" (1999) 24 *Yale Journal of International Law* 61 where a model 2x2 game is proposed for relations between securities regulators, and depending on the outcome each intends to achieve, they may play certain games such as prisoners' dilemma or relative gains that would affect the outcome of international securities regulation.

<sup>9</sup> Some interesting studies on the domestic manipulation of EU level policies are found in Morten Kallestrup, "The EU as a Pawn in Domestic Politics: Beyond Europeanization as the Explanatory Variable *per se*?"; Jens Blom-Hansen, "Europeanization or Rent Seeking?", both papers presented at the *Conference on Europeanisation: Theories and Research*, University of Copenhagen, 16 Feb 2006 ("Europeanisation conference 2006").

<sup>10</sup> This may be the case for certain issue areas such as health care services, see study by Dorte Sindbjerg Martinsen and Karsten Vrangbæk, "The Europeanisation of Health Care – Implementing the Market Imperatives of Europe"; and in the area of emissions control, see Lene Holm Pedersen, Kasper Lindskow and Yosef Bhatti, "The Europeanization of CO2 regulation in the Scandinavian countries", papers presented at Europeanisation conference 2006, *ibid*.

<sup>11</sup> See collection of papers presented in the Europeanisation conference 2006, *op cit* at n9.

interests are likely to be divergent as the EU consists of Members who are at different stages of economic development. It has been opined that developing economic jurisdictions have different economic interests<sup>12</sup> from developed jurisdictions, and since enlargement brings in many Members whose economies are developing, the heterogeneity of economic interests may impede totally convergent securities regulation. It has also been opined that London has a unique market branded by light-touch regulation<sup>13</sup> and caters mostly to wholesale capital markets. The London market has recently experienced a boom as new capital issuers have chosen London over New York after the enactment of the Sarbanes-Oxley Act 2002 in the US which required onerous reporting and compliance measures to be taken by companies.<sup>14</sup> As such, the needs of the London market may be totally different from other Member States, and London is seeking more eagerly to preserve its light-touch and principles-based regulatory approach, which may be at odds with the prescriptive approach taken under Directives such as the Prospectus Directive and the MIFID. Seeking regulatory convergence with other Member States could be viewed as damaging to the London market.<sup>15</sup> Further, Professor Andenas also argues that the historical role of financial regulation in Europe is to compliment monetary policies and limit capital flows in the domestic jurisdiction.<sup>16</sup> Hence, path dependent forces may persuade financial regulators to diverge from convergence and act in the national interest if the latter is perceived to be beneficial to domestic concerns.

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<sup>12</sup> Developing jurisdictions need more foreign direct investment and not infrastructure for sophisticated financing such as equity and derivatives markets. Speculative activities in financial markets of less developed jurisdictions could also produce economically adverse effects, as the foundations for economic development from foreign direct investment may be missed, and economic casinos such as financial markets could bring about instability. See Claudia M Buch and Christian Pierdzioch, "The Growth and Volatility of International Capital Flows: Reconciling the Evidence" in H Siebert (ed), *The World's New Financial Landscape* (Berlin: Springer 2001) at 3. See also Leslie Hull and Linda L Tesar, "The Structure of International Capital Flows" in Siebert, above, at 90.

<sup>13</sup> See discussion on the UK's principles-based regulation, as different from rules-based regulation that is the approach taken in the EU Directives and many other Member States, in chapter 2.4.2.

<sup>14</sup> "Down on the Street", *The Economist* (23 Nov 2006).

<sup>15</sup> Editorial comment, "Boardrooms Go Cold in the Single Market" (*Financial Times* 17 Oct 2006).

<sup>16</sup> M Andenas, "Who is Going to Supervise Europe's Financial Markets?" in M Andenas and Y Avgerinos (eds), *Financial Markets in Europe* (The Hague: Kluwer Law International, 2003) at xv.

Second, this chapter suggests that the substantive securities regulation have not provided a “model regulation” to foster convergence. There are two reasons for the suggestion. First, there are some areas where Member States *could* engage in regulatory competition and introduce divergence that would affect EU securities regulatory convergence. In the area of regulation of price transparency, there are potential benefits to be gained if some diversity is allowed to be introduced by Member States. That is an area which attracts forces of regulatory competition. The MIFID Commission Regulation has attempted to close as many gaps as possible in the regulation of price transparency. However, as this is an area where Member States may be attracted to forces of regulatory competition, it will be argued that Member States may still exploit a gap that is left in the Commission Regulation. Second, there are inherent gaps in the Directives, and even if these gaps are not exploited by regulatory competition among Member States, path dependency in Member States may prevail and these gaps may be left as they are, as Member States rely on pre-existing regulation. It will be argued that there are inherent gaps in the area of regulation of issuer continuous disclosure, and these gaps are likely to persist. The following will discuss how path dependence and regulatory competition will act as forces to compel Member States to retain divergences amongst their securities regulation regimes.

### *2.1 Divergences in the Regulation of Issuer Continuous Disclosure and Price Transparency*

Continuous disclosure relates to an issuer’s obligation to provide information to the marketplace at periodic intervals or at the trigger of certain conditions. There are two types of continuous disclosure, namely *periodic* continuous disclosure, and *ad hoc* continuous disclosure. Article 10 of the Prospectus Directive provides that issuers of securities traded on a regulated market of the European Union have to disclose changes made to the information in their original prospectuses issued when their securities were first floated, on a yearly basis.

<sup>17</sup> This is a form of periodic disclosure. Further, *periodic* continuous disclosure also consists of yearly and half-yearly financial and non-financial information on the issuer's performance and operations, specified in Articles 4, 5 and 6 of the Transparency Directive. Issuers also have to disclosure on an *ad hoc* basis, specific information about the issuer or its securities which may materially affect the price of those securities in the market (i.e. inside information), under Article 6 of the Market Abuse Directive. Where divergence is concerned, Member States are free to diverge on the frequency of periodic reports that issuers have to make.<sup>18</sup> Member States are also free to diverge on the issue of whether consolidation of issuer information needs to be provided and by whom.

Continuous disclosure is mandatory but the regulated is responsible for disseminating the disclosure to the beneficiaries of the information, i.e. investors. It has been argued elsewhere<sup>19</sup> that this gives rise to two issues. First, the regulated may take advantage of its dissemination responsibility and develop business models of value-added information services on top of mandatory disclosure, to sell to investors, at a price. Second, information will be more meaningful to investors if it is consolidated. Consolidation of information is practically beneficial as investors can have greater ease of access to the regulated information. Without consolidation of information, there would likely be many disparate sources of information, and if these disparate sources elude the investor, then mandatory disclosure is ultimately not delivered into investors' hands. The regulated are not compelled to consolidate issuer continuous disclosure by law.

Would national regulators engage in regulatory competition in regulating the administration of continuous disclosure? National regulators *could* regulate the business models developed

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<sup>17</sup> Article 10, Prospectus Directive.

<sup>18</sup> Article 4, Transparency Directive.

<sup>19</sup> Iris H-Y Chiu, "Delegated Regulatory Administration in EU Securities Regulation" (2007) International Lawyer (forthcoming).

by the regulated in response to their responsibility to disseminate regulated information.

National regulations may also provide regulation on the issues of frequency of disclosure, and consolidation of issuer information.

Regulatory competition allows states to produce national regulation to compete against each other, so that regulatory regimes could review and adapt themselves to provide better regulation for investors and meet industry needs. Regulatory competition also allows market forces to signal the level of optimal regulation so that regulation would not be carried out in a vacuum, and the costs imposed in regulation would not be excessive or wasteful.<sup>20</sup>

Regulatory competition also arguably avoids the unhealthy effects of centralised regulation actually performing the role of legitimating monopolistic practices and preventing innovation.<sup>21</sup>

However, there are also limits or drawbacks to regulatory competition. In terms of limits, regulatory competition would produce beneficial results if the regulatory outcomes are aligned with the preferences of the constituents. Some commentators have opined that unless constituents can threaten migration easily, regulatory regimes may not be incentivised to innovate and re-align.<sup>22</sup> Further, it has been suggested that where regulatory agencies have a cooperative as well as competitive relationship, such as between EU national regulators,

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<sup>20</sup> Roberta Romano, "Empowering Investors: A Market Approach to Securities Regulation", (1998) 107 Yale Law Journal 2359 and Roberta Romano, "The Need for International Competition in Securities Regulation", (2001) 2 Theoretical Inquiries in the Law 38. See also Stephen Choi & Andrew Guzman, "Portable Reciprocity: Rethinking the International Reach of Securities Regulation" (1998) 71 S Cal. L Rev 903. Romano suggests that issuers wherever situated should have total freedom of choice to select any regulatory regime to govern their issues. This would result in healthy regulatory competition amongst securities regulation regimes. However, see Merritt B Fox, "Protecting Investors in a Global Economy- The Issuer Choice Debate" (2001) 2 Theoretical Inquiries in the Law 863 and "The Securities Globalisation Disclosure Debate", 2000 Washington University Law Quarterly 567, where he advocates that issuer nationality would be more sensible.

<sup>21</sup> Frank H Easterbrook, "Federalism and European Business Law" (1994) 14 International Review of Law and Economics 125 where it is doubted that centralised European regulation in business is good for Member States.

<sup>22</sup> William W Bratton and Joseph A McCahery, "The New Economics Of Jurisdictional Competition: Devolutionary Federalism In A Second-Best World" (1997) 86 Georgetown Law Journal 201; Frederick Tung, "Lost in Translation: From U.S. Corporate Charter Competition to Issuer Choice in International Securities Regulation" (2005) 39 Georgia Law Review 525, 590-91 where it is discussed that the competing regulator may not wish to out-compete if the benefits to be secured are not high enough.

regulatory competition does not work towards producing optimal outcomes for constituents, as agencies may collude to achieve what they view is in their best interests.<sup>23</sup> Where regulatory competition does not take place in an idealised perfect competition type landscape, there may be a lack of resources for some regulators to compete,<sup>24</sup> and consequences such as a race to the bottom,<sup>25</sup> or eventual monopolies may occur.<sup>26</sup> It has been suggested that even where regulated firms may migrate to more favourable regulatory regimes, the cost of reincorporation and migration may be higher than remaining in the original jurisdiction.<sup>27</sup>

The drawbacks of regulatory competition not only stem from its limitations as discussed above, but that even if competition may occur, the competition between regulators is not necessarily geared towards achieving regulation most optimal for the beneficiaries of the regulation. The competition may be geared towards firm preferences and responses. It has been suggested that regulatory competition may result in a race to the bottom in situations where firms seek lowest operating cost such as in manufacturing.<sup>28</sup> Where regulators seek to protect and benefit domestic firms, regulatory standards may be high in order to keep out competing firms. Where firms have highly mobile assets, then regulatory competition may

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<sup>23</sup> John C Coffee, "Competition versus Consolidation: The Significance of Organizational Structure In Financial and Securities Regulation" (1995) 50 Business Lawyer 447. Further, a discussion on administrative agency behaviour and regulatory theories such as public choice and regulatory capture, are discussed in Steven P Croley, "Theories Of Regulation: Incorporating The Administrative Process" (1998) 98 Columbia Law Review 1.

<sup>24</sup> Daniel B Rodriguez, "Turning Federalism Inside Out: Intrastate Aspects of Interstate Regulatory Competition" (1996) 14 Yale Journal on Regulation 149.

<sup>25</sup> William Cary, "Federalism and Corporate Law: Reflections upon Delaware" (1974) 83 Yale LJ 663; Lucian Bebchuk, "Federalism And The Corporation: The Desirable Limits on State Competition in Corporate Law", (1992) 105 Harvard LR 1435; Robert A Prentice, "Regulatory Competition In Securities Law: A Dream (That Should Be) Deferred" (2005) 66 Ohio St Law Journal 1155; Amir Licht, "Regulatory Arbitrage For Real" (1998) 39 Virginia Journal of International Law 563, arguing from the old economic model provided by C Tiebout, "A Pure Theory of Local Expenditures" (1956) 64 Journal of Political Economy 416. But this simplistic criticism has been critically discussed in Bratton and McCahery, "The New Economics" (1997), op cit at n22.

<sup>26</sup> Ehud Kamar, "A Regulatory Competition Theory Of Indeterminacy In Corporate Law" (1998) 98 Columbia Law Review 1908; Renee M Jones, "Rethinking Corporate Federalism In The Era Of Corporate Reform" (2004) 29 Journal of Corporation Law 625.

<sup>27</sup> Jeanne-Mey Sun and Jacques Pelkmans, "Regulatory Competition in the Single Market" (1995) 33 JCMS 67; Eva Maria Keininger, "The Legal Framework of Regulatory Competition Based on Company Mobility: the EU and US Compared" (2004) 6 German Law Journal 741.

<sup>28</sup> Dale D Murphy, *The Structure of Regulatory Competition: Corporations and Public Policies in a Global Economy* (Oxford: Oxford University Press 2004).

take place to align regulators to firm needs, in order to keep the firms and their direct investment.<sup>29</sup>

However, it is also suggested that the 4 fundamental economic freedoms in the Treaty of Rome should give rise to a positive attitude towards regulatory competition, as competition could be relied on to pave the way for the liberalisation of markets. Wolfgang Kerber<sup>30</sup> argues that regulatory diversity is a necessary feature of the EU as no amount of regulatory harmonisation could remove all regulatory differences, especially in the areas of tax regimes, labour regulation, environmental regulation, as well as differences pertaining to cost of infrastructure in different Member States. In other words, as Member States cannot have identical regulatory regimes in all areas, it would be undue to seek total convergence for the internal market. Thus, it may be better to view the differences positively and see how these differences create variety for businesses choices and whether market forces may indicate regulatory lessons. Uniform rules on any particular issue may be optimal and efficient for one Member State but may not be so for another, and diversity allows each Member State to find its equilibrium. Others have also argued that regulatory diversity is part of the framework envisaged under the overarching principle of subsidiarity and healthy forms of it ought to be maintained.<sup>31</sup>

A model of vertical regulatory competition has been suggested as suitable for the EU.

Wolfgang Schön<sup>32</sup> argues that the landscape for perfect regulatory competition does not exist in the EU in many issue areas, and hence, there is room for some “verticalisation” i.e. the

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<sup>29</sup> Ibid.

<sup>30</sup> “Inter-Jurisdictional Competition within the EU” (1998) 23 Fordham International Law Journal 217.

<sup>31</sup> Horatia Muir Watt, “Experiences From Europe: Legal Diversity and the Internal Market” (2004) 39 Texas International Law Journal 429. Christian Kirschner also argues that economic principles could be applied to interpret subsidiarity. Any economic rationale for centralising an aspect of EU governance may at the same time arguably be economically unsound for another Member State, and so centralisation should be carefully considered. See “The Principle Of Subsidiarity In The Treaty On European Union: A Critique From A Perspective Of Constitutional Economics” (1998) 6 Tulane Journal of International and Comparative Law 291.

<sup>32</sup> Wolfgang Schön, “Playing Different Games: Regulatory Competition in Tax and Company Law Compared” (2005) 42 CMLR 331.



provision of standards at the EU level, in order to provide a combined governance of minimum standards with an amount of healthy competition. He proposes the vertical competition model, which allows certain minimum standards to be set at the EU level, or provision of pan-European regimes such as the “SE”, that serve as an alternative to national regimes. This may prevent a race to the bottom, and minimum harmonisation still allows national regulators to innovate and compete amongst themselves to maintain diversity for the needs of their different constituents.

On the other hand, regulatory competition may not lead to perpetual diversity. Market forces may result in certain demand-preferred Member States having a large share of the extra-territoriality of its interpretation and application of the Directives across Europe. This may foster demand-driven convergence upon the most preferred Member State, much like the American “Delaware” effect, where regulatory competition has produced a winner. The production of a winner is however not always a celebrated achievement. The “winner” may mean stagnated regulation and a controversially mediocre regime representing a “race to the bottom”.<sup>33</sup> This may not be what is intended in the original goal towards regulatory convergence. However, “race to the top” theorists have provided evidence that regulatory competition could produce overall higher standards, such as where prospectus disclosure is concerned. Global competition for securities listings seems to have selected the stringent prospectus regime of the United States as the most preferred amongst investors, and hence, most private placements in the EU are modeled on US prospectus disclosure.<sup>34</sup>

CESR has already foreseen that there are gaps in the regulation of continuous disclosure that could give rise to national divergences. On the issue of consolidation of continuous disclosure,

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<sup>33</sup> Robert A Prentice, “Regulatory Competition In Securities Law: A Dream (That Should Be) Deferred” (2005) 51 Duke LJ 1397; Renee M Jones, “Rethinking Corporate Federalism In The Era Of Corporate Reform” (2004) 29 Journal of Corporation Law 625; Ehud Kamar, “A Regulatory Competition Theory Of Indeterminacy In Corporate Law” (1998) 98 Columbia Law Review 1908.

<sup>34</sup> Howell E. Jackson, and Eric J. Pan, “Regulatory Competition in International Securities Markets-Evidence from Europe 1999 Part I” (1999) 56 Business Lawyer 653.

CESR in its Report<sup>35</sup> on storage and consolidation of regulated information, recommended that each Member State appoint Officially Appointed Mechanisms (“OAM”) to collect, store and allow access to issuer continuous disclosure, within certain agreed technical benchmarks and specifications. CESR also proposed that there should be a centrally run database independent of all Member States that provides a comprehensive directory of all EU issuers and links to the relevant OAM. If this Report is adopted by the Commission, it may mean that some form of vertical regulation may be adopted, reducing the scope for divergences arising out of regulatory competition. As the Report is being considered by the Commission, this thesis will first consider the default situation, i.e. that there is no verticalisation of the regulation of continuous disclosure, and that Member States are free to engage in regulatory competition.

### ***Issuer Disclosure***

For the issue of frequency of issuer periodic disclosure, differences in national regulation will only matter if an issuer decides not to admit its securities to trading in a particular jurisdiction due to the continuous disclosure regime that will be imposed. However, secondary markets can admit an instrument to trading without an issuer’s consent. Hence, differences in national regulation will not affect the appearance of an issuer’s securities on any market in any Member State. As such, there is arguably no necessity for any Member State to engage in regulatory competition over the frequency of periodic reporting for fear of losing issuers from its jurisdiction’s markets. However, Member States may see the continuous disclosure regime, particularly the frequency of reporting, as an attractive factor for investors. It has been written at length that investor protection laws are particularly important to the strength of a securities market, and the US markets are a manifestation of that connection between strong securities

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<sup>35</sup> CESR’s Final Technical Advice on Possible Implementing Measures Concerning the Transparency Directive: Storage of Regulated Information and Filing of Regulated Information, CESR 06/292, June 2006.

laws and markets.<sup>36</sup> Thus, Member States may engage in regulatory competition in the regulatory design of periodic reporting as part of its efforts to make its regime attractive to investors and hence, issuers. As the Transparency Directive allows such divergences to be introduced,<sup>37</sup> Member States could diverge in terms of the frequency of periodic reporting, as well as what needs to be contained in those reports. The contents of reports are important as they relate to different types of investor needs, and different investors may be attracted to invest in securities governed by regimes that require certain types of reporting.<sup>38</sup>

As *Centros*<sup>39</sup> has allowed companies to have the freedom of establishment anywhere in the EU, it is conceivable that companies may choose incorporation in a jurisdiction that may offer a preferred regulatory regime for securities offerings. Contrary to race to the bottom suggestions that companies will choose least cost jurisdictions to govern their securities offerings, and be subject to lax regulation, the US markets have shown that companies choose regimes of strong securities laws to govern their offerings to appeal to investors.<sup>40</sup> Thus, having a continuous disclosure regime that is relevant to attracting investors, arguably influences incorporation decisions of companies. That is an incentive for Member States to engage in regulatory competition. Further, the more a jurisdiction attracts incorporation of companies with a view to being subject to its securities offering regime, the more that jurisdiction is able to extend extra-territorial control over issuers whose issues may be listed in other Member States, but who are ultimately governed by the home country's regime wherever they may be traded. The "network" effect of such extra-territorial control brings about reputational benefits to a jurisdiction's regime and will likely be attractive to more

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<sup>36</sup> Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Schleifer, "What Works for Securities Laws?" (2006) 56 *Journal of Finance* 1.

<sup>37</sup> Article 4.

<sup>38</sup> The nature of different types of information, particularly non-financial information, in issuer disclosure is discussed in I Chiu, "The Paradigms of Mandatory Non-Financial Disclosure- Parts I and II" (2006) *Company Lawyer* 259 and 291.

<sup>39</sup> Case C-212/97 *Centros Ltd. v. Ervervsog Selskabsstrylsen* [1999] ECR I-459.

<sup>40</sup> John C. Jr, Coffee, "The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications" (1999) 93 *Northwestern. University. Law Review* 641; Black, "The Legal Conditions" (2000) at n136.

issuers and investors.<sup>41</sup> The potential for regulatory competition between Member States in designing periodic continuous disclosure may play out the kind of “issuer choice” competition discussed by several eminent American academics.<sup>42</sup> Issuer choice theorists posit that where issuers are able to choose their regime of regulation, their products compete for investors based on investors’ preferences for the regulatory regime behind the products. Such competition is likely to enhance investor empowerment, and allows securities regulation to evolve to reach an optimal regime that investors actually prefer. It is arguable that regulatory competition in the design of periodic continuous disclosure may give rise to issuer choice.

On the other hand, there are other reasons why investors are attracted to particular securities regimes. La Porta et al identified that a key factor is the availability of good civil liability regimes for investor compensation against issuer breaches.<sup>43</sup> Hence, it is uncertain if regulatory competition in the design of periodic continuous disclosure regulation may be crucial to Member States’ efforts in attracting investors and hence issuers. Further, as markets in the EU may admit securities for secondary trading without an issuer’s consent, an issuer may gain exposure to a wide base of investors without needing to exert effort on its own. Hence, issuers may not be motivated to select regulatory regimes for periodic disclosure that they think would most appeal to investors, as investors may buy securities anyway in a market close to home.

In sum, it may be arguable whether there would be sufficient motivation for Member States to engage in regulatory competition in regulating periodic continuous disclosure. In the absence of regulatory competition acting as a motivating force for Member States Member

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<sup>41</sup> See Robert B Ahdieh, “Making Markets: Network Effects and the Role of Law In the Creation of Strong Securities Markets” (2003) 76 South California Law Review 277.

<sup>42</sup> See n20.

<sup>43</sup> La Porta et al, “What Works” (2006), op cit at n36.

States are likely to succumb to path dependency<sup>44</sup> in retaining the divergent periodic reporting obligations they already have.

Where consolidation of issuer continuous disclosure is concerned, it will be argued that regulators are unlikely to engage in regulatory competition to provide regulation in their own jurisdictions. National regulators are unlikely to be incentivised to engage in regulatory competition on the issue of consolidation, because there are no incentives on the supply side of regulation, and insufficient incentives on the demand side as well.

On the supply side of regulation, regulators would more likely than not wish to attract the regulated into the market to generate economic benefit for the jurisdiction or even just to generate regulatory rent. However, are there incentives for regulators to compete? If regulators are not competitive, would the regulated choose to move out of the regulator's jurisdiction?<sup>45</sup>

Issuers of securities are largely attracted to markets that investors prefer. Investor preferences have been studied to lean towards strong disclosure laws, and market depth and liquidity.<sup>46</sup> Issuers may be concerned with regulatory cost, but higher standards of public offer disclosure that impose high regulatory cost have not deterred issuers because of the potential gains from a larger and stronger market. Thus, issuers may happily absorb regulatory cost associated with continuous disclosure. Even if a firm may be affected by the regulatory cost of continuous disclosure, the scope for regulatory competition in this issue in EU Member States is very small. Continuous disclosure imposes regulatory cost, and if a jurisdiction does not impose continuous disclosure, as compared to a jurisdiction that does, then the savings in

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<sup>44</sup> See discussion on path dependency in Part 7.

<sup>45</sup> See Bratton and McCahery, "The New Economics" op cit at n22; Keininger, "The Legal Framework of Regulatory Competition" op cit at n27.

<sup>46</sup> Jackson and Pan, "Regulatory Competition" (1999) op cit at n34. Marc I Steinberg, "Emerging Capital Markets: Proposals and Recommendations for Implementation" (1996) 30 International Lawyer 715; La Porta et al, "What Works" (2006), op cit at n36.

regulatory cost may be attractive to issuers, although markets themselves may impose their own continuous disclosure requirements. Since the EU Directives already impose continuous disclosure, then regulatory competition in whether or not disclosure requires consolidation, is not going to significantly distinguish one jurisdiction from another. The imposition of central and consolidated issuer disclosure is not likely to add that much cost to the issuer, and is not likely to affect an issuer's decision whether or not to incorporate in a jurisdiction. Further, as the Directives provide for home state control, the regulator responsible for supervising and enforcing continuous disclosure is the home regulator of the issuer. Many issuers would already have home ties based on original incorporation, and are unlikely to choose to reincorporate just because the home state imposes consolidation of continuous disclosure. However, for would-be corporations that could choose the incorporation venue for the first time, the attractiveness of the regulatory regime will be crucial, as seen in the *Centros* case.<sup>47</sup> However, factors such as tax regimes and corporate governance regimes may be more crucial to an incorporation decision than whether a regulator imposes consolidated continuous disclosure.<sup>48</sup>

It may be argued that a regulator may be incentivised to provide consolidated continuous disclosure as investors may demand it. Such an investor-friendly jurisdiction could attract a larger and stronger investor base and in turn make markets in that jurisdiction more attractive. This argument works in the US as the US SEC is a federal agency and consolidates all issuer disclosure in one place. It also leverages on the electronic filing system for issuers, in providing for investor searches, and thus, the service for investors may not cost the SEC that much.<sup>49</sup> Where the EU is concerned, as there is no central EU agency for securities regulation,

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<sup>47</sup> Case C-212/97 *Centros Ltd. v. Ervervsog Selskabsstrylsen* [1999] ECR I-459.

<sup>48</sup> Schön, op cit at n32.

<sup>49</sup> The gross operating cost of the department of Corporate Finance running the EDGAR system is USD\$127,000 in 2005 and \$92,000 in 2004, and if EDGAR is a portion only of that cost, then the regulatory cost to the SEC is not very significant compared to the benefits it brings to investors. The SEC's statistics and increased EDGAR hits is reported in SEC Annual Reports 2005 and 2004, available on [www.sec.gov](http://www.sec.gov). Enhanced

and 25 home regulators exist to deal with the corporations they are responsible for, any consolidated information held by national regulators is still disparate to investors. Investors have to first find out which home regulator is responsible for the issuer they wish to look into, before they may be able to retrieve any information. Hence, there may not be many incentives for investors to demand that national regulators keep consolidated information of the issuers they are responsible for.

It is suggested that, in the absence of any vertically imposed rule, regulators will unlikely engage in active regulatory competition over the issue of consolidating issuer disclosure. However, that means that each jurisdiction may succumb to path dependent forces and be content to leave its default position as it is. Some Member States have regulators or exchanges that regulate some form of consolidation of information, such as the UK Financial Services Authority, or the Frankfurt Stock Exchange. The UK Listing Authority, which is the FSA, authorises primary information service providers to provide consolidated information free of charge. Other terms such as sale charges to secondary disseminators and terms of contract are left to the market.<sup>50</sup> The Frankfurt Stock Exchange has a Board of Admissions which receives the quarterly reports from listed companies and posts them on the Exchange website, providing a form of a consolidated source for issuer information, but is limited to issuers listed on that Exchange.<sup>51</sup> In the UK, the consolidation of information is regulated but outsourced, and in Germany, provision of consolidated information is at the Exchange's discretion and initiative. This arguably engenders as much divergence as if regulators engaged in regulatory competition. In the absence of regulatory competition, it is submitted

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information services under the XBRL are to replace EDGAR in the few years to come, see Jeremy Grant, "SEC's Cox Looks to Revolutionise Disclosure" (Financial Times 3 Oct 2006).

<sup>50</sup> See Financial Services Authority, *Review of the UK Mechanism for Disseminating Regulatory Information by Listed Companies* (London: FSA, Consultation Paper 92, 2001) and FSA, *Proposed Changes to the UK Mechanism for Disseminating Regulatory Information by Listed Companies* (London: FSA Policy Statement, November 2001). See E Ferran, *Building an EU Securities Market* (Cambridge: CUP 2004) at 193ff.

<sup>51</sup> Section 63, Exchange Rules for the Frankfurt Stock Exchange, available at [http://www1.deutsche-boerse.com/INTERNET/EXCHANGE/zpd.nsf/KIR+Web+Publikationen/HAMN-52CDY7/\\$FILE/FWB01e-06-10-16.pdf?OpenElement](http://www1.deutsche-boerse.com/INTERNET/EXCHANGE/zpd.nsf/KIR+Web+Publikationen/HAMN-52CDY7/$FILE/FWB01e-06-10-16.pdf?OpenElement) (accessed Oct 2006).

that path dependence in Member States will result in the retention of prevailing systems and thus, divergences, among Member States.

### ***Regulation of Price Transparency***

Market transparency refers to the visibility of pre-trade and post-trade information.<sup>52</sup> Pre-trade information refers to information regarding offer prices and volumes on markets, and includes those offered by market-makers. Such information can take a variety of forms, it could be information on the current bids or firm quotes for a security; it could include trading depth; it could be the best 5 offers at different depths; it could even be the whole limit order book as constantly updated. Post-trade information refers to information on concluded transactions, perhaps including price and volume of securities transacted, and may include time, venue and counterparties to transactions. Investment firms (that carry out systematic internalisation for securities that have liquid markets), alternative trading systems which are defined as Multi-lateral Trading Facilities (MTFs), and regulated exchanges need to provide pre-trade transparency information in terms of the 5 best current bids/offers and trading depths at the offers concerned,<sup>53</sup> and post-trade transparency information of concluded transactions in terms of volume, price and time.<sup>54</sup>

For price transparency, it will be argued that there will be incentives for national regulators to engage in regulatory competition. National regulators may engage in regulatory competition that attracts exchanges to their jurisdiction. It is arguable that exchanges have a certain amount of mobility and may be incentivised to re-incorporate should the need arise. Thus,

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<sup>52</sup> For a discussion on the nature of transparency, see Board, Sutcliffe and Wells, *Transparency and Fragmentation* (London: Palgrave Macmillan 2002).

<sup>53</sup> Articles 29 and 44, MIFID, and Article 24, MIFID Commission Regulation.

<sup>54</sup> Articles 30 and 45, MIFID, and Article 27, MIFID Commission Regulation.



national regulators keen to attract or keep exchanges within their jurisdiction could be incentivised towards a race to the bottom.

As most EU exchanges are corporations, exchanges can choose to be incorporated in the most favourable home jurisdiction, and provide services across the EU.<sup>55</sup> The MIFID also dismantles barriers to access to regulated markets, and hence, wherever a market is incorporated, its provision of services across the EU is not supposed to be impeded. Although it has been argued that reincorporation is not a real option for many firms, and thus, regulatory competition is not a really active phenomenon in the EU,<sup>56</sup> this thesis suggests that reincorporation incentives may be rather strong for exchanges. First, exchanges rely on information sale to generate revenue, and hence, if regulation affects their key business, then it would not be inconceivable for exchanges to choose to reincorporate.<sup>57</sup> Second, the “European Company” structure<sup>58</sup> could arguably help exchanges, as an exchange could reincorporate as an “SE” and choose its registered office in a Member State whose regulatory regime it prefers. The SE Regulation also allows for subsequent changes to be made to the location of the registered office of the SE.<sup>59</sup> Third, exchanges are undergoing a wave of internationalisation by merging with each other. Nasdaq has acquired almost a quarter of the London Stock Exchange by end 2006, although the Exchange has rejected all acquisition offers, including from Nasdaq, to date; the New York Stock Exchange and Euronext are in merger talks by the same time, not to mention that Euronext itself is a merger of Paris, Brussels, Amsterdam and Lisbon national exchanges, and Norex is a merger of the Scandinavian, Icelandic and Latvian exchanges. The mergers of exchanges allow

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<sup>55</sup> Passport for markets, see Article 42(6), MIFID.

<sup>56</sup> Sun and Pelkmans, “Regulatory Competition”, Keininger, “The Legal Framework of Regulatory Competition”, both op cit at n27.

<sup>57</sup> This is discussed in detail in Chiu, “Delegated Regulatory Administration” (2007), op cit at n19.

<sup>58</sup> Council Regulation 2157/2001, which entered into force on 8 Oct 2004. A useful analysis is found in Frank Wooldridge, “The European Company: The Successful Conclusion of Protracted Negotiations” (2004) 25 Company Lawyer 121 and Erik Werlauff, “The SE Company: A New Common European Company from 8 Oct 2004” (2003) 14 EBLR 85.

<sup>59</sup> Article 8, Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE), OJ L 294/1.

opportunities for new identities to be created, and that could also mean reincorporation where appropriate.

As reincorporation may be a viable alternative for exchanges, there may be incentives for regulators to align their regulation in such a way so as not to jeopardise their relationships with the exchanges. This may entail divergent practices across the EU, as a form of regulatory competition.

Although the MIFID Commission Regulation has spelt out in great detail how price transparency is to be reported, in terms of frequency<sup>60</sup> (3 minutes within the close of trade or the next opening day of trade for trades conducted after hours), contents of disclosure,<sup>61</sup> standards of reporting (i.e. timely, and verified),<sup>62</sup> limited and specific conditions for any deferral of reporting and waiver<sup>63</sup> and publication of the information,<sup>64</sup> the Commission Regulation has left a tiny gap in its regulation. Article 32(b) requires the regulated to report consolidated information from similar sources to its market. However, no further detail is provided as to how consolidation of price transparency information is to be regulated. CESR's Level Three recommendations<sup>65</sup> also do not provide guidance on consolidated information, as the guidelines seek to clarify how exchanges should discharge the Regulation's specifications, such as how "close of trade" is to be defined in terms of determining if post-trade information ought to be disclosed,<sup>66</sup> and whether information should be posted on websites<sup>67</sup> or be available in certain formats.<sup>68</sup> Hence, how information may be consolidated, how much amount of information needs to be consolidated, and what

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<sup>60</sup> Article 29, MIFID Commission Regulation.

<sup>61</sup> Articles 17, 21, 24 and 27.

<sup>62</sup> Article 29 and 32.

<sup>63</sup> Articles 28, 33 and 34.

<sup>64</sup> Article 30.

<sup>65</sup> CESR, *Publication and Consolidation of MIFID Transparency Data* (Feb 2007), available at [http://www.cesr-eu.org/index.php?page=document\\_details&from\\_title=Documents&id=4228](http://www.cesr-eu.org/index.php?page=document_details&from_title=Documents&id=4228).

<sup>66</sup> Guideline no. 6, *ibid*.

<sup>67</sup> Guideline no. 5, *ibid*.

<sup>68</sup> Recommendation no. 2, *ibid*.

information needs to be consolidated, are arguably left to the regulated. The regulatory administration of consolidation is delegated to the regulated, in terms of how and what to consolidate, the mechanics of delivery and the quality of consolidation. This gives rise to room for national regulators to step in and provide regulation on the mechanics and standards of consolidation. National regulators may even decide to be the main consolidator themselves and then provide the same information to commercial disseminators at a fee, as it is under the Consolidated Tape and Quotation Systems administered by the US Securities Exchange Commission. Further, as the MIFID Commission Regulation does not provide facilitative regulation for the regulated to access the market data of comparable markets, the regulated may argue that it would be difficult and costly to discharge the consolidation duty effectively. There is thus room for national regulators to regulate how market information should be shared or pooled.

The gap left in the regulation of consolidated price transparency information may incentivise regulators to engage in regulatory competition. This is because any regulation in this area may affect the business and revenue of markets and information disseminators, and may result in reincorporation decisions. Although the gap may be small, where the forces for attracting regulatory competition exist, even small gaps may arguably be exploited by national regulators.

## *2.2 Lack of Integration of EU Securities Markets*

Next, it is arguable that regulatory divergences are likely to persist as divergences reflect the state of fragmentation in EU securities markets. The current securities laws do not sufficiently bring about an integrated capital market in the EU, as there appears to be no “market integration strategy” similar to the National Market System in the United States. The

National Market System is an initiative started in the 1970s in the US.<sup>69</sup> In a National Market System, the objective to be attained is that no matter where an issuer may choose to list its securities, this would not prevent investors trading in other markets from trading in those securities concerned.<sup>70</sup> Although the exact measures of the System were left to be implemented by the SEC, the SEC has taken a systematic and flexible approach<sup>71</sup> to ensure maximum exposure of investor orders to all market centers. For issuers, this also represents maximum exposure for their securities to investors. The National Market System has however also attracted criticism that it stifles the working of competitive forces in markets by compelling a form of order centralisation.<sup>72</sup> However, where the EU is concerned, European markets have always been fragmented, although the introduction of the euro has paved the way for cross-border movements of capital to be made more easily, and greater inter-dependence between markets have been gradually fostered.<sup>73</sup> However, as there is still insufficient integration in Europe's capital markets,<sup>74</sup> it may be in the interests of the EU to consider if a National Market type initiative may be necessary to facilitate the greater exposure of investor orders to markets in the EU. In the present default position, the EU is likely to maintain pools of liquidity in terms of the large separate exchanges such as the London Stock Exchange, Euronext-NYSE and Deutsche Börse. However, bottom-up initiatives such as the initiative of investment banks to form a large pan-European trading platform may provide a form of integration in securities markets.<sup>75</sup>

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<sup>69</sup> For a brief policy description and objectives of the National Market System, see Arthur Levitt, "Preserving and Strengthening the National Market System for Securities in the United States", SEC Testimony before the Senate Committee on Banking, Housing and Urban Affairs, 8 May 2000, available at <http://www.sec.gov/news/testimony/ts082000.htm> (accessed Dec 2006).

<sup>70</sup> Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 7, 89 Stat. 11 (codified at 15 U.S.C. § 78k-1(a)(2) (1976)).

<sup>71</sup> Joel D Seligman, "The Future of the National Market System" (1984) 10 *Journal of Corporation Law* 79.

<sup>72</sup> Corinne Bronfman et al., "The SEC's Market 2000 Report" (1994) 19 *Journal of Corporation Law* 523.

<sup>73</sup> European Central Bank and Centre for Financial Studies, *Research Network on Capital Markets and Financial Integration in Europe* (Final Report, Dec 2004) available at <http://www.eu-financial-system.org/report2004en.pdf> (accessed Dec 2006).

<sup>74</sup> Tobias Buck, "EU to Act on Creating Single Financial Services Market" *Financial Times* (2 May 2005).

<sup>75</sup> "Banks Blitz Exchanges" *Financial Times* (16 Nov 2006) where it is reported that several large investment banks, including Citigroup, Deutsche Bank and Merrill Lynch are linking up to provide a single trading platform for securities.

## ***Regulation of Markets***

The MIFID has put into place maximum access provisions regarding regulated markets, in prescribing that regulated markets must have open and fair rules in admitting financial instruments to trading,<sup>76</sup> admitting intermediaries to membership,<sup>77</sup> and Member States must provide non-discriminatory access to clearing and settlement facilities.<sup>78</sup> Regulated markets may also admit securities to trading without the issuer's consent,<sup>79</sup> thereby allowing a European security to feature in many markets. It may be argued that these provisions seek to assist investors to access securities that are traded on markets outside of one's own jurisdiction. However, compared to a National Market System, such access is still not easily achieved.

Where there is a lack of either privately fostered market linkages, or an imposed mandate to link markets up, an investor in the UK who is interested in a Lithuanian stock listed on the OMX cannot place an order to trade straightaway. The hypothetical investor would have to look for a Lithuanian stock that is also listed on a UK market, or look for a broker that has membership in the OMX in order to place the order. Market linkages or a National Market would allow an investor who wishes to place an order for a stock traded on the OMX to enter his order into the system of his UK market, which would then be matched in any of the systems linked up in the National Market. The MIFID leaves the issue of market linkages to home regulators and market forces. National regulators may leverage on fragmentation of markets and engage in divergent practices, if these divergent practices assist in building up national markets that are distinct and competitive on a global landscape. The competition between markets is not just between European markets but also with markets in the United

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<sup>76</sup> Article 40, MIFID.

<sup>77</sup> Article 42, MIFID.

<sup>78</sup> Article 34, MIFID.

<sup>79</sup> Article 40(5), MIFID.

States, and an exchange such as the London Stock Exchange has always been proud to be unique and effectively competitive *vis a vis* its American counterparts, such competitiveness being a result of deregulation and allowing divergent competitive practices to arise.<sup>80</sup>

Competitive forces on a global scale may encourage Member States to prefer building up their distinct national market over building up a pan-European market where the national market is merely a point of entry.

Further, the passport regime is limited for operators of regulated markets. Article 43(6) of the MIFID provides for freedom to provide services of a regulated market in another Member State once authorised in a home state. This is slightly different from an earlier draft Article 34(5) of the draft MIFID which deemed a regulated market as authorised in another Member State, once authorised in the home state. It seems therefore that the passport arrangement is somewhat limited, i.e. that a national market is probably not allowed to set up a branch as such, but is allowed to open its portal to the users in other Member States. This restraint seems to fly in the face of freedom of establishment<sup>81</sup> in the common market, by limiting the right of stock exchange access to merely a freedom to provide services<sup>82</sup> in a host state.<sup>83</sup>

The limited passport for markets seems to be contradictory to any market integration strategy. Professor Wymeersch believes that central to European integration in securities markets is the

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<sup>80</sup> John Kay, "Big Bang Shows Power of Competition to Surprise" *Financial Times* (23 Oct 2006).

<sup>81</sup> Article 48 of the EC Treaty, see brief discussion in A Arnall et al, *Wyatt and Dashwood's European Union Law* (London: Sweet and Maxwell 2000), at 464ff.

<sup>82</sup> Art 49, EC Treaty, see brief discussion in Arnall, *Wyatt and Dashwood*, *ibid*.

<sup>83</sup> The difference between the scope of the two freedoms is discussed in Jesper Lau Hensen, "Full Circle: Is there a Difference Between Freedom of Establishment and Freedom to Provide Services?" in M Andenas and W Roth (eds), *Services and Free Movement in EU Law* (Oxford: OUP 2000) at 197. The general limitations to freedom to provide services is wide, as general good exceptions are allowed if the freedom is restrained, while for freedom of establishment, only an exception falling within Article 46 *order public* is allowed. See Hensen who supports the view that there is a difference in the scope of exceptions allowed for the two freedoms, and Miguel Polares Maduro who supports the view that courts are taking a unified approach to interpreting the freedoms and exceptions, see "Harmony and Dissonance in Free Movement" in Andenas and Roth (eds), *Services*, above, at 41.

inter-connectedness and linkages between stock exchanges.<sup>84</sup> He envisages that stock exchange linkages will be created to provide privileged access for investment firms having pan-European operations. This will also create a common trading platform for issuers, i.e. that issuers listed on one exchange may become listed automatically in the sister exchanges in other Member States. The current limitations will constrain the level of exposure a pan-European exchange can have in a host Member State.

Although it may be argued that intermediaries will still be able to service their clients across European markets, as the MIFID provides that they should be allowed access to regulated markets,<sup>85</sup> there are some cross-border inconveniences and risks for investors. Intermediaries who service clients in cross-border orders may impose a higher cost than for domestic transactions. An intermediary that maintains many memberships across European markets would possibly have to pass on the cost to investors. A full passport for markets could also allow the trading of securities denominated in the different currencies of Europe, and may serve as a hedging possibility for some investors. For example, a passported London Stock Exchange could provide listing services for dual listings in both pounds sterling and euros.

If a market could be passported to operate in another jurisdiction, investors can access such a market directly from home, in the absence of National Market-type linkages. This possibility may increase investor interest in participating in new markets across the EU, and in turn stimulate market mobility. If a foreign choice is brought to the doorstep at home, investor

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<sup>84</sup> Eddy Wymeersch, "Regulating European Markets: The Harmonisation of Securities Regulation in Europe in the new Trading Environment" in E Ferran and C Goodhart (eds), *Regulating Financial Services* (Oxford: Hart 2001) at 189ff, 196-9. However, some believe that price transparency can be achieved by market competition alone, see Corinne M Bronfman, "If it Ain't Broke, Don't Fix It" in K Lehn and Robert W Kamphuis Jr (eds), *Modernising US Securities Regulation: Economic and Legal Perspectives* (Irwin Publishing 1993) at 407ff.

<sup>85</sup> Articles 33 and 42, MIFID.

interest could arguably be encouraged to a larger extent, than if the foreign choice is just “available” somewhere out there in Europe, through intermediaries.<sup>86</sup>

In the absence of a National Market system policy at the EU level, it is arguable that the Directives will continue to allow the proliferation of distinct and fragmented markets that could challenge the integrating effects intended by regulatory convergence. The following Part discusses how the MIFID will continue to allow fragmented pools of liquidity to persist in the form of “unregulated markets”.

### ***Unregulated Markets***

One of features in the MIFID that may augment market fragmentation across the EU is the phenomenon of the “unregulated markets”. The MIFID provides for a regulated markets regime, but Member States are able to allow unregulated markets to operate in their own jurisdictions, and submit only certain national markets as regulated markets under the Directives. Some second tier markets may not be designated by their responsible home states as “regulated markets” subject to MIFID’s regulation. Thus, these markets would be entirely regulated by their home regulator, and would be allowed to maintain features that would be distinct from competitors. Regulators may engage in regulatory competition to cater for the needs of their second tier markets, as these could attract issuers of small and medium sized enterprises across Europe. Listing business is important to second tier markets, and as discussed, markets may have a certain amount of mobility and incentives to reincorporate. Thus, regulators are likely to be incentivised to engage in regulatory competition to maintain differences catering for the second tier markets they are responsible for. The UK FSA, faced

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<sup>86</sup> There is however a study that suggests that retail interest in pan-European equity offerings is very limited, and this may extend to secondary trading as well. International Financial Law Review, *European Financial Services Forum* (21 Apr 2004), Panel Discussion on the Prospectus and Transparency Directives, quoted in Ferran, *Building* (2004) op cit at n50, at 201.



with possible foreign takeover of the London Stock Exchange, is already worried that possible American ownership of the Exchange and its subsidiary, the second tier Alternative Investment Market (“AIM”) may affect its regulatory advantages, and has hence initiated and supported the passing of legislation that allows the regulator to veto changes to Exchange rules.<sup>87</sup> This example shows that regulators are concerned enough about the listing business of the exchanges they are responsible for, and do engage in regulatory competition to maintain comparative advantages.<sup>88</sup>

An example of an unregulated market is the AIM, operated by the London Stock Exchange, which has opted out of the “regulated markets” regime of the MIFID. The new second tier market set up by Euronext, Alternext, has also opted out, and this has been followed by the Open Market, which is a new platform for small listings on the Deutsche Börse.<sup>89</sup> The move to “opt-out” may have been prompted by the new Prospectus Directive, as the Directive removes the distinction between the listed and unlisted markets to cover all public offers to be made over any regulated market. Issuers going to a second tier market which is “regulated” will have to comply with stringent disclosure and continuous disclosure obligations under the Market Abuse and Transparency Directives as well. This would defeat the purpose of going to a second tier market which has hitherto provided cost savings for an issuer compared to a listed market. The second tier markets aforementioned may have been scared away from opting in as “regulated”, as the one-size regulation under the Prospectus Directive may erode the attractiveness of their hitherto lighter-touch and more flexible rules.

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<sup>87</sup> Sections 300B-D of the Financial Services and Markets Act 2000, as amended by the Investment Exchanges and Clearing Houses Act 2006.

<sup>88</sup> Davis Lascelles, “Mergers are no Cure-all for Exchanges” *Financial Times* (22 May 2006), where it is reported that profits are declining for exchanges in competing for trade orders. The next big business for exchanges may be in listing rather than in trading. See also Laura Nyantung Beny, “US Secondary Stock Markets: A Survey of Current Regulatory and Structural Issues and a Reform Proposal to Enhance Competition” (2002) *Columbia Business Law Review* 399 at 464.

<sup>89</sup> Brian Groom, “Eurozone is Thinking Small Again” *Financial Times* (14 April 2005). See Norma Cohen, “Deutsche Börse jumps on Smallcap Bandwagon” *Financial Times* (10 Oct 2005), and “Europe’s Small-Cap Stock Markets- A Bigger Pool for the Winnows” in *The Economist* (8 Oct 2005).

Further, fragmented pools of liquidity such as standalone MTFs are arguably “unregulated markets”, causing more fragmentation to the markets landscape.<sup>90</sup> These pools of liquidity may be significant markets if large volumes of trade by institutional investors are done through them for the benefit of anonymity. It may also be questioned as to whether or not issuers can by-pass all markets and set up direct internet public offers (complying with the Prospectus Directive on content of the prospectuses and Article 14 on distribution which includes posting on the offeror’s Internet website) accompanied by a simple MTF that matches buy/sell orders.<sup>91</sup>

It may be argued that fragmentation can be combated with price transparency regulation and the best execution duty imposed on intermediaries. If intermediaries owe a duty of best execution, they have to find the markets with the best terms for their clients. Thus, a broker’s duty to look at different markets serves to “link” markets up for investors, as a broker is obliged to compare the markets.<sup>92</sup> However, as discussed, the regulation of price transparency is not comprehensive at the moment, and without sufficient consolidation of price transparency information, a broker may still be regarded as having discharged his duty if he compared his trade with a benchmark market, without going into other markets. Hence, it may be too remote at the moment to rely on price transparency and best execution regulation to provide a *de facto* market integration strategy.

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<sup>90</sup> Article 40(5), MIFID.

<sup>91</sup> As was carried out by Spring Street Breweries in the US in 1995. Spring Street Breweries Ltd introduced its first Internet Direct Public Offer (Internet DPO) in 1995 in 18 states in the US after concluding that it could not afford to raise finance via the traditional method on exchange. The DPO was made under Regulation A of the US Securities Act 1933 and the jurisdictional supervision of the SEC. It was also registered in 18 states in the US. Spring Street by-passed all intermediaries by using in-house preparations and by posting and disseminating the required information on the Internet. The Internet DPO resulted in substantial cost-saving. Spring Street raised \$1.6 million in the first tranche and \$5 million in the second. See D E Giddings, “An Innovative Link between the Internet, the Capital Markets and the SEC: How The Internet Direct Public Offering helps Small Companies Looking to raise Capital” (1998) 25 Pepperdine Law Review 785, and G Sinclair, “Internet Direct Public Offerings-New Opportunities For Small Business Capital Finance” (2000) 27 Manitoba Law Journal 297.

<sup>92</sup> Article 44, MIFID Commission Directive.

It may be argued that it is best to rely on market forces to create integrated markets. In recent years, several exchanges have merged to appeal to a wider base of investors. The wave of mergers of exchanges seen in the creation of Euronext, and the Scandinavian<sup>93</sup> and Baltic Exchanges,<sup>94</sup> may be the market's way of meeting actual investor needs. Thus, even second tier markets can engage in such cross-border linkages. However, merged markets may actually result in fragmented and oligopolistic pools of liquidity, not actually achieving market linkages of the type in a National Market System. In practical reality, the merged exchanges still operate national entry points and different parts of a merged entity, situated in different Member States, have different rule books and different businesses.<sup>95</sup> Thus, the merged exchange itself may still be a product of market and regulatory competition and perpetuate market fragmentation across the EU.<sup>96</sup> Further, markets are now largely demutualised and operate as businesses,<sup>97</sup> which would be chiefly concerned about staying competitive. The profit motivation need not necessarily align markets towards integration if maintaining divergences may be regarded as being more competitive.

### **3. Individual or Selected Multi-Speed Actions by National Regulators**

As discussed, regulatory competition, path dependency and contextual factors such as the fragmentation of securities markets could perpetuate regulatory divergences among Member States. Other incentives to diverge include domestic political and bureaucratic influences.

One such reason may be the “public choice” view of regulators, that regulators are interested in augmenting and consolidating their status and turf, and thus, they may engage in practices

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<sup>93</sup> The Norex, a consolidated exchange of the Scandinavian exchanges, Iceland and Latvia, later expanded to form the OMX, *infra*.

<sup>94</sup> The Baltic exchanges in Lithuania, Latvia and Estonia have formed the OMX, see report in *The Economist* (21 Oct 2004).

<sup>95</sup> The Euronext is a combination of the Paris, Amsterdam, Brussels and Lisbon exchanges but they each specialise in different types of securities.

<sup>96</sup> Ferran, *Building* (2004), op cit at n50.

<sup>97</sup> The business behaviour of exchanges is discussed in Ferran, *ibid* at 236ff.

that are self-interested, whether those practices are cognisant or otherwise of convergence.<sup>98</sup>

Alternatively, Stigler has suggested that national regulators respond to regulatory capture by significant domestic interest groups.<sup>99</sup> Even if regulators are cognisant of EU level interests, they may be constrained by domestic bureaucratic and political forces in the process of national transposition. John Tattersall<sup>100</sup> has opined that national implementation is deeply affected by national consultation and inter-agency consultation within the government.

In a fast-paced industry such as securities regulation, there are many competitive pressures in international securities markets. Capital mobility has been greatly increased over the years as a result of diversity in products,<sup>101</sup> improvements in technology, and investment demand.<sup>102</sup> Such competitive pressures have provoked much discussion in how securities regulation may develop internationally,<sup>103</sup> and whether international strategies in securities regulation may remove as many capital market barriers as possible.<sup>104</sup> However, individual regulators with

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<sup>98</sup> Zecher and Phillips maintain a “public choice” view of the US SEC. See Susan M Phillips and J Richard Zecher, *The SEC and the Public Interest* (Massachusetts: The MIT Press 1981).

<sup>99</sup> G Stigler, “The Theory of Economic Regulation” (1971) 2 *Bell Journal of Economics and Management Science* 3. See also M Condon, *Making Disclosure* (Toronto: Toronto University Press 1998) which examines to what extent regulators regulate according to their professed goals.

<sup>100</sup> Speech at HM Treasury seminar, London, May 2004, . John Tattersall also presented a table showing the state of national implementation and only a handful of Member States have fully implemented the Accounting Directive (Austria and Italy, albeit late).

<sup>101</sup> See Jeremy W Markham, “Super-Regulator” (2003), op cit at n8 .

<sup>102</sup> The growth of pooled investment vehicles such as funds which are tied in with consumer needs for pension planning have released much money into the capital markets. See “Mervyn’s Message to Financial Markets”, *Financial Times* (18 January 2006).

<sup>103</sup> Uri Geiger, “The Case for the Harmonisation of Securities Rules in the Global Market” (1997), op cit at n5; J William Hicks, “Harmonisation of Disclosure Standards for Cross-Border Share Offerings: Approaching an International Passport to Capital Markets?” (2001) 9 *Indiana Journal of Global Legal Studies* 361; Dimity Kingsford Smith, “Networks, Norms and the Nation State: Thoughts on Pluralism and Globalised Securities Regulation” in Catherine Dauvergne (ed), *Jurisprudence for an Interconnected Globe* (London: Kluwer Law International, 2003), in which the role of IOSCO as a source of soft law in a pluralistic landscape is discussed. Troy L Harder, “Searching for a Level Playing Field- The Internationalisation of US Securities Disclosure Rules” (2002) 24 *Houston Journal of International Law* 345; Herbert V Morais, “The Quest for International Standards: Global Governance vs Sovereignty” (2002) 50 *University of Kansas Law Review* 779 discuss international standards convergence.

<sup>104</sup> Douglas J Arner, “Globalisation of Financial Markets-An International Passport for Securities Offerings?” (2001) 35 *International Lawyer* 1543 proposes “global shares” that could be offered and traded in any state; Hal Scott, “Internationalisation of Primary Public Securities Markets” (2000) 63 *Law and Contemporary Problems* 71, proposed “off-shore free zones” i.e. that certain zones could be designated for global securities offerings in an experimental manner. In such an off-shore free zone, issuers could select which regulatory regime should govern their securities and regulatory competition can thus occur. Marc I Steinberg and Lee E Michaels, “Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches, Commonality and Reciprocity” (1999), op cit at n5, propose “international offerings” based on a universally convergent prospectus issued by IOSCO. IOSCO could classify different countries into different “compliance bands”, so

the full range of regulatory powers responding to such challenges, may still be susceptible to taking quick decisions in the short term, and in the long term, significant divergence may be created in EU securities regulation.

Professor Stephen Weatherill opines that “ Market Integration [generates] problems of inconsistent application and enforcement. States have short term incentives to break rules [at Community level] and, if this is not effectively controlled, the domino effect will cause the collapse of the system”.<sup>105</sup>

Besides individual divergences by regulators, “multi-speed” actions may also be undertaken by regulators who may form closer associations with each other, perhaps because of proximity, or shared areas of cross-border regulation. Professor Klaus Goetz suggests that European convergence often occurs in clusters or families of Member States that have greater affinity or resemblance with each other, based on geographical proximity and factors such as the time a Member State acceded to the EU.<sup>106</sup> The early days of EU securities regulation has already seen regional clustering in the form of “Club Med” countries’ preferences against “North Sea” countries’ preferences, where issues of market transparency and market concentration were concerned.<sup>107</sup> An analogy from the theories of regionalism in trade law issues may also provide some insight as to how divergences in national securities regulation may occur.

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that a value could be assigned to the regulatory regimes offered by every jurisdiction. A higher –valued jurisdiction could be then acceptable by other states as a regulatory regime that that state’s investors could rely on. A lower-valued state would be regarded as more unwelcome in other states.

<sup>105</sup> Stephen Weatherill, *Law and Integration in the European Union* (Oxford: Clarendon, 1995) at 284.

<sup>106</sup> “Beyond Differential Impact: Families of Nations, Centre-Periphery and Regional Clusters of Europeanisation”, paper presented at conference “Europeanisation: Theories and Research” at the University of Copenhagen, 16 Feb 2006.

<sup>107</sup> E Wymeersch, ‘Control of Securities Markets in the European Economic Community’, ‘Commission of the European Communities, Collection Studies, Competition Approximation of Legislation Series No 31 (1978), quoted in L Gharzaniti, “Single Market-Making- EC Regulation of Securities Markets” (1993) Company Lawyer 43.

Some theories of regionalism suggest that individuals or groups of like-minded players may form closer “regions” in trade in spite of multilateral arrangements being in place. This is because multilateral arrangements only address minimum levels of similarities among large numbers of participants. Remaining differences that are not overcome in multilateral arrangements may then encourage individual divergences. However, participants may find smaller groups of like-minded participants who share higher levels of similarity among themselves than the minimum level of similarities accepted in the multilateral arrangements. Thus, individual States may create bilateral relations or regional arrangements.<sup>108</sup>

Regionalism takes place because of the cumbersome strictures of negotiations with too large a number of participants. The enlarged EU of 27 may arguably be fertile for “regionalism”. Regionalism may also occur because, as discussed in chapter 3, national regulators are not equivalent in powers, resources and competencies, and thus, like regulators may form closer relationships with each other. It may be arguable that select “multi-speed” actions that differentiate some regulators from others, and do not promote simultaneous convergence, may be justified under the recent political acceptance of “enhanced cooperation” set out in the Treaty of Amsterdam.<sup>109</sup> Multi-speed actions may also be likely given that some regulators, such as Scandinavian regulators, may have closer cooperation ties with each other due to joint supervision over large merged exchanges, such as the OMX.

There are well-documented views on the destructive nature of regionalism for multilateral arrangements.<sup>110</sup> However, some trade theorists have viewed regionalism very differently.

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<sup>108</sup> M Schiff et al, *Trade Blocs* (Washington: The World Bank, 2000).

<sup>109</sup> This is however argued to be limited, see John Usher, “Enhanced Cooperation or Flexibility in the Post-Nice Era” in Anthony Arnall and Daniel Wincott (eds), *Accountability and Legitimacy in the EU* (Oxford: Oxford University Press, 2002). See also Bruno de Witte ““Old Flexibility”: International Agreements Between Member States of the EU” in G de Búrca and J Scott (eds), *Constitutional Changes* (Oxford: Hart, 2000) at 31, where it is argued that varying speed actions have in general not undermined integration. Daniel T Murphy also argues that enhanced cooperation is within the control of the European Commission as it has to initiate the proposal, and thus, the threat to divergence may be more supposed than real. See “Closer or Enhanced Cooperation: Amsterdam or Nice” (2003) 31 *Georgia Journal of International and Comparative Law* 265.

<sup>110</sup> The negative views towards regionalism and the potential to undermine multilateral arrangements are discussed in J Bhagwati, “Regionalism and Multilateralism: An Overview” in J De Melo and A Panagariya (eds), *New Dimensions in Regional Integration* (London: CEPR 1993) and J Bhagwati and A Krueger, *The Dangerous*

They are of the view that regional agreements are generally facilitative and act as a pre-cursor to multilateral acceptance of the arrangements. Regionalism may ultimately improve multilateral arrangements.<sup>111</sup> It is arguable that divergences amongst Member States may be temporary and would ultimately entail convergent practices. This is akin to the recent opinion of Professor Majone who argues that integration in the EU generally will occur by “stealth”.<sup>112</sup> However, in terms of securities regulation, market and industry players usually favour certainty and coherence over dynamic and transitory processes.<sup>113</sup> Furthermore, large players who are used to dealing with the one-stop shop and legal certainty practiced by the US SEC, which is the single regulator for US securities markets, may be uncomfortable with disparate structures in the EU, even if such structures may be dynamically moving towards a form of consolidation in the future. Finally, the fast-paced demands and changes in the securities industry and markets as discussed above may make this issue area unsuitable for integration by gradual role-modeling and stealth. The rapidity with which changes occur in the securities industry may mean that responsive regulators may take regulatory leaps ahead of the rest of the pack, and create a gap that gets perpetually widened and may not be closed.

In the absence of a cybernetic system at the EU level that can direct Member States towards regulatory convergence, there exist real possibilities for Member States to diverge. Before this chapter closes, this thesis will survey consociational theories and the role of European institutions in achieving regulatory convergence in EU securities regulation.

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*Drift to Preferential Trade Agreements* (Washington: American Enterprise Institute 1995). See also Edward D Mansfield and Helen V Milner, “The New Wave of Regionalism” (1999) 53 *International Organisation* 589. Others also think that regionalism is based largely on political needs and thus, the effects of selfish divergence need not produce beneficial effects upon the multilateral system as a whole. See Gene M Grossman and Elhanan Helpman, “The Politics of Free Trade Areas” (1995) 85 *The American Economic Review* 667.

<sup>111</sup> Bergsten argues that regionalism acts like a hothouse for certain trade arrangements which could be experimentally carried out and then adopted on a wider multilateral scale. F Bergsten, *Open Regionalism* (Washington: Institute for International Economics 1997). Baldwin also argues that regionalism produces a domino effect upon others. Richard E Baldwin, “The Causes of Regionalism” (1997) 20 *World Economy* 865. See also Wilfred J Ethier who opines that regionalism is largely used by smaller states to gain a foothold into the multilateral system, “The New Regionalism” (1998) 108(449) *The Economic Journal* 1149.

<sup>112</sup> Giandomenico Majone, *Dilemmas of European Integration* (Oxford: OUP 2005).

<sup>113</sup> Reflected in the IIMG Third Report, Nov 2004.

#### 4. A Consociational Theory of Regulatory Convergence

It may be argued that CESR's governance could provide a consociational influence that may overcome the diverging forces described above, and help facilitate towards regulatory convergence.

Consociational theory,<sup>114</sup> has been used to explain how plural and segmented societies remain stable and coherent democracies. This theory may be used by analogy to discuss CESR.<sup>115</sup>

Consociational theory posits that commitment to similar values binds plural and segmented players together, and thus, convergent directions can still be taken by all players. However, for consociational solutions to be reached, there should be existing conditions of mutual interdependence, so that each participating unit cannot walk away and refuse to cooperate.

Each participant must also have a certain commitment to maintaining the cohesiveness of the group. Then will such units bargain with each other and achieve a joint resolution of matters.<sup>116</sup> In chapter 2, it was discussed that the nature of CESR resembles a "regime" within the meaning in international relations studies, and in a "regime", participants are generally mutually inter-dependent on each other, as more may be achieved by cooperation than without. If CESR is "consociationally stable", i.e. that the inter-dependent relationships in CESR are strong and members are more likely to cooperate than to disengage, then, the cooperative tendencies of members could lead them to forge consensus rather than divergence. A survey of CESR members may show that some participants may be less mutually dependent on others, than other participants. For example, the UK FSA may be a

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<sup>114</sup> Arend Lijphart, "Consociational Democracy" (1969) 21 *World Politics* 207; *Democracy in Plural Societies: A Comparative Exploration* (New Haven CT: Yale University Press 1977). Brian Barry however challenged Lijphart's 1968 thesis by providing contrary research to show that the foundational consociational conditions for Switzerland, Austria, Belgium and Netherlands were lacking for these democracies which Lijphart classified as "consociational", but Barry did not negate the usefulness of this theory altogether. See B Barry, "Political Accommodation and Consociational Democracy" (1975) *British Journal of Political Science* 477.

<sup>115</sup> Consociational theory has been used to describe the stability of the European Union itself, but the view is somewhat taken at a "macro" level, as opposed to the analogical application to CESR as a network. See Matthew J Gabel, "The Endurance" (1998) 30 *Comparative Politics* 463.

<sup>116</sup> Pierre du Toit, "Consociational Democracy and Bargaining Power" (1987) 19 *Comparative Politics* 419.



rather independent player as the London Stock Exchange and other UK markets are rather strong and have good international presences of their own. Scandinavian regulators who are also bound together in their supervision of the OMX, the merged Scandinavian exchange, may also have closer ties with each other than with perhaps other players of the South. Further, consociational theories have been used to explain social stability in diverse countries such as Switzerland, and there may be stronger incentives for citizens of the same country to achieve coherence in diversity than for regulator participants in a transnational network. Thus, it is easier for regimes such as CESR to be subject to individual members' preference changes, and the consociational stability of CESR is arguably not well-established.

Comparing the forces for consociational interdependence and the drivers of divergence such as regulatory competition, it is arguable that consociational interdependence *per se* would not provide sufficient impetus to adopt regulatory convergence. Forces of divergence such as regulatory competition are likely more attractive to Member States, especially in terms of short term economic incentives, for the advancement of various domestic and national interests.<sup>117</sup> Consociational interdependence is based on practical dependence and is not ideology, and thus, it provides modification of behaviour where a need is perceived, but such modification need not be sufficient for convergence, or be permanent. It is only where an ideology of convergence, which resists divergent interests, is accepted as an institution of values for all national regulators, that they can be bound together in the direction of convergence.

In order to secure an ideology of convergence amongst Member States, a process of institutionalisation of EU securities regulation should be commenced. However,

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<sup>117</sup> Dale D. Murphy, *The Structure of Regulatory Competition: Corporations and Public Policies in a Global Economy* (2004), op cit at n28.

before the discussion moves on to the institutionalisation of regulatory convergence in chapter 6, a brief discussion will be made on the role of European institutions to provide the needed regulatory convergence.

## **5. Regulatory Convergence by the Jurisprudence of the European Court of Justice?**

Moving onto the supranational institutions of the EU, it may be argued that interpretation of Directives ultimately rests with the European Court of Justice, and thus, the Court may be able to provide a unifying interpretive jurisprudence for the Internal Market. The Court's role has been important in creating a body of jurisprudence for the freedom of movement of goods<sup>118</sup> and services,<sup>119</sup> and hence, it may be argued that its role could be significant in the regulatory convergence of EU securities regulation.

First, the preliminary ruling procedure under Article 234 of the Treaty of Rome allows national courts to make a reference to the European Court to make a preliminary ruling on the interpretation of any aspect of European Communities law. Such an interpretive ruling would then become binding on the national court and could also be regarded as interpretive precedent in subsequent cases, establishing a foothold in the national jurisprudence.<sup>120</sup>

However the preliminary ruling is often based on a specific point of interpretation referred by the national Court.<sup>121</sup> It is arguably impractical to rely on Article 234 to create a unifying jurisprudence for the whole of EU securities regulation, as Court interpretation would be piecemeal and ad hoc. However, significant rulings by the Court, especially with reference to

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<sup>118</sup> See *Cassis De Dijon* Case 120/78, *Rewe-Zentral AG V Bundesmonopolverwaltung für Branntwein* [1979] E.C.R. 649; however limited by *Keck and Mithouard*, joined cases C-267-268/91 [1993] ECR. I-6097. See generally, Arnall et al, *Wyatt and Dashwood* (2003), op cit at n80 at 321ff.

<sup>119</sup> *Union Royale Belge des Sociétés de Football Association v Bosman*, Case C-415/93 [1995] ECR. I-4921; *Alpine Investments BV v Minister van Financien* Case C-384/93 [1995] E.C.R. I-1141. See generally, Andenas and Roth (eds), *Services and Free Movement in EU Law* (2002), op cit at n83.

<sup>120</sup> Lenore Jones, "Opinions of the Court of the European Union in National Courts" (1997) 28 New York University Journal of International Law and Politics 275. Also Stephen Weatherill, "Can there be Common Interpretation of European Private Law?" (2002) 31 Georgia Journal of International and Comparative Law 139.

<sup>121</sup> See for example, *CILFIT Srl v Ministero della Sanita*, Case 77/83, [1984] ECR 1257.

how freedom of movement of capital is to be interpreted, could lay down important principles for convergence. For example, in a recent reference, the Court was of the view that the old Listing Particulars Directive, under which the issue for reference arose, was based on a general principle of minimum harmonisation, and thus, the Italian and Greek governments were allowed to impose liability on persons the Directive was silent on.<sup>122</sup> The Court did not deal with the current securities Directives that were not in issue and did not comment on whether the current Directives were based on maximum harmonisation instead of minimum harmonisation. However, it is arguable that if the case arose, the Court could decide if the current securities Directives are premised on regulatory convergence and provide guidelines on how to interpret individual provisions accordingly.

On the other hand, the power of the Court to secure integration also depends largely on national referral. If the national court refuses to refer due to “acte clair”, then an issue would not proceed to the European Court. Under the “acte clair” doctrine, if an interpretation is obvious to a national court, then the national court would be competent in finally resolving such issue.<sup>123</sup> Further, the European Court may decide that it has no jurisdiction to interpret a provision in national legislation based on a Directive, if the situation in which the case arose is entirely national in character, or relates to purely internal situations and does not give rise to an “unconditional reference” at Community level.<sup>124</sup> There are no *meta* principles governing the initiative to refer, and the Court cannot compel a national court to refer, and hence, there is no systematic approach as to how the European Court may provide a body of jurisprudence for national implementation of Directives. Although national courts have

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<sup>122</sup> Case C-430/05, *Reference for a preliminary ruling from the Simvoulia tis Epikratias by order of that court of 31 August 2005 in Dionik Anonimi Etairia Emporias I/I, Logismikou & Parokhis Ipirision Mikhanografisis (Dionik A.E.) and Ioannis Mikhail Pikoulas v Epitropi Kefalaiaogoras*, OJ 2006 C60/16, see opinion of Advocate-General Sharpston, 8 March 2007.

<sup>123</sup> Case 283/81, *Srl CILFIT and Lanificio di Gavardo SpA v Ministry of Health* [1982] E.C.R. 3415.

<sup>124</sup> Case C-28/95, *Leur Bloem* [1997] E.C.R. I-4161; Case 130/95, *Giloy* [1997] E.C.R. I-4291 seemed to articulate the “unconditional reference” as a limit to the ECJ’s jurisdiction, but the ECJ has not yet applied this condition to reject any case. See also Silvere Lefevre, “The Interpretation of Community Law by the Court of Justice in Areas of National Competence” (2004) 29 ELR 501.

frequently invoked the preliminary reference procedure,<sup>125</sup> the power of the European Court *per se* in securing integration of EU securities regulation jurisprudence is arguably uncertain.<sup>126</sup>

The European Court has also espoused that national courts should interpret national law in a way that gives effect to the Directives.<sup>127</sup> However, there are limitations to this, as courts' interpretive duty can conceivably go no further than "interpretation".<sup>128</sup> It still has to interpret the relevant transposing national law in a way that does not distort the meaning of national law.<sup>129</sup> The Court's espousal in *Van Colson* also does not relate to issues of convergence. Achieving a convergent effect in interpretation of a Directive is more demanding than just "giving effect" to a Directive. Moreover, there are at present no defined standards of convergence for a national court to evaluate "convergence".

Generally however, the strength of influence on national jurisprudence by the European Court is considerable.<sup>130</sup> Furthermore, Kenneth Armstrong and Simon Bulmer are also of the view that the European Court of Justice would provide the key to Single Market integration through jurisprudence interpreting the freedoms.<sup>131</sup> Thus, the interpretation of EU securities regulation may be taken within the context of freedom of movement of capital, and, as suggested earlier, a higher level of unifying jurisprudence may be provided by the Court, in interpreting Article 73b (freedom of movement of capital). However, the slowness of the

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<sup>125</sup> From July 2005-6, there were 544 cases referred to the Court of Justice for preliminary rulings, data obtained from Westlaw search.

<sup>126</sup> Thomas de la Mare, "Article 177 in Social and Political Context" in Paul Craig and Gráinne de Búrca (eds), *The Evolution of EU Law* (Oxford: OUP 1999) at 215. However, George and Takis Tridimas point out that public choice theory explains why litigants would invoke EC law, and national courts would make references to the ECJ purely out of self-interest and that could still facilitate a large measure of integration. See "National Courts and the European Court of Justice: A Public Choice Analysis of the Preliminary Reference Procedure" (2004) 24 *International Review of Law and Economics* 125.

<sup>127</sup> *Sabine van Colson and Elisabeth Kamaan v Land Nordrhein-Westfalen* [1984] ECR 1891.

<sup>128</sup> Arnall et al argue that this duty is in fact a duty to give effect to the Directive in spite of national law, see Arnall et al, *Wyatt and Dashwood* (2000), op cit at n81 at 94.

<sup>129</sup> *Paola Faccini Dori v Recreb Srl* [1994] ECR. I-3325.

<sup>130</sup> Lenore Jones "Opinion" (1997), op cit at n119. See also Martin Shapiro, "The European Court of Justice" in Paul Craig and Gráinne De Búrca (eds), *The Evolution* (1999), op cit at n126 at 321.

<sup>131</sup> *Governance of the Single European Market* (Manchester: Manchester University Press 1998) at 265.

process in building up judicial jurisprudence may not cohere well with the needs of market participants operating in a rapidly changing capital markets landscape. In the US, the unification of administrative securities law under the Securities Exchange Commission has achieved the most significant results in terms of improving the attractiveness of the US markets. Furthermore, the Directives have all provided for the primacy of administrative sanctions against securities breaches, and so reliance is placed on regulators to achieve convergence and not the Court. Therefore, there may not be many opportunities for the European Court to provide jurisprudence in interpreting securities Directives. On the other hand, where administrative rulings are appealable to a national court,<sup>132</sup> there is room for national courts to carry out divergent interpretation as issues of national administrative law are involved.<sup>133</sup> Actions of appeal against administrative rulings are unlikely to be referred to the European Court. It may be argued that recourse to the European court may still be possible if there are any issues that may need resolution under the European Convention of Human Rights, such as if the administrative ruling did not take into account of fair and due process. However, Court's attention would be drawn to the issue relating to the Convention on Human Rights and may only indirectly relate to the substantive securities laws.

In chapter 2,<sup>134</sup> it is argued that the only way for the Court to provide an integrative jurisprudence for convergence in securities regulation is under Article 226 of the Treaty of Rome that gives the court jurisdiction to determine if Member States have failed to transpose Directives into national legislation in a convergent way. If the court has jurisdiction to rule on the level of convergence achieved, then an integrative jurisprudence for convergence may be built up.

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<sup>132</sup> For example, see Article 26, Prospectus Directive.

<sup>133</sup> National courts have faced particular problems in reconciling administrative law with EU rights and this can be seen in the *Factortame* case (C 221/89) [1991] ECR I-3095, detailed discussion may be found in I Ward, *Critical Introduction* (London: Butterworths 1996) at 89ff.

<sup>134</sup> Also I Chiu, "A Meta-Legal Principle for Achieving Regulatory Convergence in EU Securities Regulation", paper presented at conference "Europeanisation: Theories and Research", University of Copenhagen, 16 Feb 2006.

## 6. The Role of the European Commission

It may be argued that the provision of control over convergence for “EU securities regulation” could come from the European Commission through policy decisions.

However, it is submitted that the Commission will not likely be able to provide sufficient control over Member States to ensure convergence. The Commission is a general EU institution that deals with overviews of many issue areas, and sets general policy directions. Although the Commission has undertaken specific policy-making and regulation in merger regulation under Competition law,<sup>135</sup> the Commission does not have a dedicated outfit to provide systematic control over regulatory convergence in securities regulation. It is currently undertaking a more overall review role in terms of the whole Internal Market. The Commission reviews the progress of EU securities regulation annually by tasking the Inter-Institutional Monitoring Group to make yearly reports on Internal Market implementation.

Further, it may be argued that as regulatory convergence demands a high level of consensus, the Commission must be able to provide that single-minded approach towards regulatory convergence. An insightful study into Commission officials and their preferences shows great divergences in Commission officials’ views on whether the Internal Market should be regulated by a heavy hand or a light hand.<sup>136</sup> Therefore, the institutionalisation of regulatory convergence for EU securities regulation may not even be achieved within the Commission.

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<sup>135</sup> See chapter 6.

<sup>136</sup> Liesbet Hooghe, *The European Commission and the Integration of Europe* (Cambridge: Cambridge University Press 2001) in which interviews were conducted with 137 Commission top officials to ascertain four fundamental matters, whether the officials see the Commission as supranational or intergovernmental, whether the officials believe the Commission should prefer regulated market capitalism or a more laissez faire approach, whether the Commission should be run as a consociational or Weberian organisation, and whether the Commission should favour more democratic accountability or technocratic exercise of its functions. Commission officials diverge significantly on all 4 issues, but generally most prefer supranationalism for the Commission, although they are split down the middle between the consociational or Weberian forms of

Although the Commission has responsibility for enacting Level Two legislation in EU securities regulation, it has been argued earlier<sup>137</sup> that one should not regard Level Two delegated legislation as the Commission's means in controlling regulatory convergence. Level Two measures are arguably constrained and subject to a sunset clause, and hence, the Commission may be unable to undertake a continuous role in shaping EU securities regulation. Even if the Commission may make other forms of non-binding decisions in its capacity as the executive arm of the EU,<sup>138</sup> it may not be apt to rely on the Commission, as CESR would be developing codes, principles and interpretive guidelines in the implementation and application of EU securities laws across Member States, and any further Commission "soft law" may become confusing to the regulated and to market participants.

Finally, the Commission may be affected by enlargement so that policy-making in the Commission may become slow and cumbersome, having to navigate a variety of interests.<sup>139</sup> On the other hand, studies have shown that the speed of decision-making in the EU is unlikely to be affected by enlargement.<sup>140</sup> Further, the draft Constitution has envisaged this problem and provides for a maximum limit on the number of Commissioners to be at 15, and the appointment of non-voting Commissioners who could assume voting positions by rotation, so as to satisfy Member States' representational interest.<sup>141</sup>

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organisation. More believe in democracy than technocracy, and they are split down the middle in terms of regulating the Internal Market.

<sup>137</sup> Part 2.4.3, chapter 2.

<sup>138</sup> The Commission's exercise of "governmental powers" is frowned upon by John Temple Lang, "The Commission: The Key to the Constitutional Treaty for Europe" (2003) 26 *Fordham International Law Journal* 1598.

<sup>139</sup> Whether enlargement would affect speed of decision-making has been studied by several political scientists and views are mixed. See Thomas König and Thomas Bräuninger, "From an Ever-Growing towards an Ever-Slowing Union?" and Rachel Brewster, Michael Munger and Thomas Oatley, "Widening Versus Deepening the European Union: An Institutional Analysis" in Madeleine O Hösli, Adrian van Deemen and Mika Widgren (eds), *Institutional Challenges in the EU* (London Routledge 2001) at 155 and 48 respectively.

<sup>140</sup> Heiner Schultz and Thomas König, "Institutional Reform and Decision-Making Efficiency in the EU" (2000) 44 *American Journal of Political Science* 253.

<sup>141</sup> See Roger J Goebel, "The European Union in Transition- The Treaty of Nice in Effect, Enlargement in Sight, the Constitution in Doubt" (2004) 27 *Fordham International Law Journal* 455. See also Michael Dougan, "The Convention's Draft Constitutional Treaty-Bringing Europe Closer to its Lawyers" (2003) 28 *ELR* 763.

In sum, the Commission is probably too removed from the specific agenda of EU securities regulation convergence, and is constrained by role of “general overview” to provide effective and direct control for regulatory convergence.

## **7. Market Forces for Convergence**

According to the cybernetic model benchmark, systematic regulatory convergence may not likely be achieved within the current framework, however, it is arguable that convergence may be driven by commercial forces. This type of convergence may however be gradual, episodic,<sup>142</sup> weak<sup>143</sup> and incomprehensive.

A number of eminent commentators have discussed convergence in corporate governance regulation,<sup>144</sup> and analogical analyses may be adduced here to discuss the prospects of regulatory convergence in securities regulation and the forces driving divergence or convergence.

Hansmann and Kraakman’s seminal argument for convergence in corporate governance is posited upon the observation that more and more people save through investments in securities, favouring a dispersed shareholding corporate governance structure that also requires strong securities laws to support such an investment pattern.<sup>145</sup> There are certain key

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<sup>142</sup> In that the convergence takes place in selected areas only from time to time, and is not consistent or persistent.

<sup>143</sup> In that the convergence may not be formal convergence, but functionally equivalent convergence. See Ronald Gilson, “Globalising Corporate Governance: Convergence of Form or Function” in Gordon and Roe (eds), *Convergence and Persistence*, *infra*, at 128.

<sup>144</sup> Jeffrey N Gordon and Mark J Roe (eds), *Convergence and Persistence in Corporate Governance* (Cambridge: Cambridge University Press 2004).

<sup>145</sup> Henry Hansmann and Reiner Kraakman, “The End of History for Corporate Law” in Jeffrey N Gordon and Mark J Roe (eds), *Convergence and Persistence* (2004), *ibid* at 33.



characteristics of “strong securities laws”<sup>146</sup> which have been identified such as insider dealing enforcement, comprehensive disclosure obligations upon issuers and continuing disclosure obligations. These are the foundations of the current Directives as well, and thus, it may be argued that fundamentally, the substantive laws are poised to converge, although the devil may be in the details. As such, convergence in EU securities regulation may occur at higher levels of principles such as strong disclosure and enforcement against market abuse, and dialogic learning among regulators in CESR may later patch the detailed fragmentation in interpretive, supervisory and enforcement convergence. Other arguments to support ultimate convergence are that convergence achieves greater efficiencies for cross-border activity, whether from the regulators’, regulated’s or investors’ perspectives. Furthermore, if developing EU economies are keen to seek investment capital, they may regard laws that are convergent with established securities jurisdictions as attractive to issuers and investors.<sup>147</sup>

However, as argued earlier, there are many incentives for divergence, and arguments from local conditions and efficiency can lead to path dependent behaviour on the part of national regulators who may resist too much change in converging with the regulatory approaches of other Member States. Bebchuk and Roe’s theory of path dependence<sup>148</sup> argues that where local rent may be sought by the controller of the firm, corporate governance regulation will be path dependent and not convergent. This analysis may be applied analogically to the regulator’s behaviour as well. However, under increasing cross-border competition, the size of local rent may become minimised and if so, then the gradual disappearance of such incentives may cause regulators to adopt changes. However, path dependence may still be

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<sup>146</sup> Bernard Black, “The Legal and Industrial Preconditions for Strong Stock Markets” (Stanford Law School Working Paper No. 179, 2001).

<sup>147</sup> The modelling effect of established securities regulations is however doubted in Katherine Krause, “European Union Directives and Poland” (2006) 27 University of Pennsylvania Journal of International Economic Law 155.

<sup>148</sup> Lucian Bebchuk and Mark J Roe, “A Theory of Path Dependence in Corporate Ownership and Governance” in Gordon and Roe (eds), *op cit* at n144 at 69.

due to embedded factors such as the political, social and cultural frameworks,<sup>149</sup> and these may be much harder to overcome.

There is a balance of forces in the EU securities regulation arena to promote and to slow down convergence.<sup>150</sup> As such, the net result may be episodic, weak and incomprehensive convergences, each spurred by different overriding objectives. For example, the convergence on international accounting standards is an example where cross-border efficiencies and the need to provide more attractive and competitive regulation outweighed incentives to extract local rent. This however may be contrasted with the MIFID where the incentives to converge have been acknowledged to be weaker.<sup>151</sup>

## 8. Conclusion

This chapter argues that there are several drivers that may induce regulatory divergence in EU securities regulation. Consociational theories and the institutional roles of the European Court and the Commission were also discussed, to show that these influences are arguably insufficient to control or direct towards regulatory convergence. Part 7 then discusses the commercial forces supporting and resisting convergence, and concludes that, in the absence of a cybernetic system for regulatory convergence, the type of convergence to be achieved, if any, is likely to be episodic, weak and incomprehensive, quite different from the systematic and comprehensive convergence earlier envisaged. The next chapter will discuss the institutional implications of the original vision of regulatory convergence.

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<sup>149</sup> Ibid. and Reinhard Schmidt and Gerald Spindler, "Path Dependence and Complementarity in Corporate Governance" in Gordon and Roe (eds), *Convergence and Persistence*, *ibid* at 114; Mark J Roe, "Modern Politics and Ownership Separation" in *ibid* at 252; and Curtis J Milhaupt, "Property Rights in Firms" in *ibid*, at 210.

<sup>150</sup> Such a balance is also discussed in David Charny, "The Politics of Corporate Convergence" in Gordon and Roe (eds), *Convergence and Persistence*, *ibid*, at 293.

<sup>151</sup> Tobias Buck, "Dream of MIFID Harmony at Risk, EU told", *Financial Times* (21 Feb 2007).

## Chapter 6

### Institutional Implications for Regulatory Convergence

#### 1. Introduction

In this chapter, it is argued that a cybernetic system for regulatory convergence in EU securities regulation may be brought about by a process of institutionalisation. Institutions may be defined as systems of rules and norms, or systems of values, symbols, relational structures, routines or artefacts.<sup>1</sup> The general idea underlying an *institution* is that institutions embody systems, and systems are bounded sets of “order” that maintain continuity of operation, and provide relative stability and persistence, in a cybernetic way. The order within the system may be subject to change and modification, but the system itself will have rules and processes to determine the implementation of change.

The political science and sociological definitions of an “institution” are both based on a pattern of rules or norms that form an almost formal structure, so that systematic operation of the rules and norms may attain the objectives of the system.<sup>2</sup> Thus, an institution attains a systemic structure by virtue of the unifying strength of its rules and norms. As it has been argued in chapters 2 and 3, one of the features of the current EU securities regulation landscape is the multitude of *selectors* for regulatory norms, in the sources of laws, administration and interpretation of laws, supervision as well as enforcement of laws. This

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<sup>1</sup>W Richard Scott, *Institutions and Organisations* (London: Sage 2001)(2<sup>nd</sup> edition) at 71ff. See also Lynne G Zucker, “The Role of Institutions in Cultural Persistence” (1977) 42 *American Sociological Review* 726.

<sup>2</sup> The political science definition can be summed up in “normative patterns of behaviour to solve problems of cooperation in a social context, providing a more or less permanent platform for conflict resolution”, see C Mantzavinos, *Individuals, Institutions and Markets* (Cambridge: Cambridge University Press 2001), and the sociological definition can be summed up as “rule-like, social-fact quality of an organized pattern of action [external] and an embedding in formal structures, not tied to particular actors or situations [internal]” (parenthesis mine), see Lynne Zucker, “Institutional Theories of Organisation” (1987) 13 *Annual Review of Sociology* 443.

feature causes likely fragmentation in the substantive national laws as well as the law in action. Such fragmentation affects the achievement of a cybernetic system for regulatory convergence. If an institution can be established at the EU level to provide the unifying norms for regulatory convergence in the law in books as well as law in action, then perhaps a systemic structure for regulatory convergence may be achieved in due course. It may be argued that if the policymakers in the EU had chosen to use Regulations instead of Directives to implement all primary legislation, the multitude of national *selectors* would not come into play, and therefore, the existing EU governance would have an institutional structure to provide regulatory convergence. The decision to forego Regulations in favour of Directives represented the policymakers' preference, and they would have certainly been aware of the effects on regulatory convergence.

However, there are four aspects to regulatory convergence, as earlier discussed. Even if Regulations were selected for the enactment of primary laws, thus, minimising the *selector* problem at the sources of laws, there would still be issues of administration, supervision and enforcement where fragmentation could arise. This is because there is no EU agency for securities regulation, and the administration of the laws and supervisory functions would be delegated to national regulators. Besides, there may also be a limit to what Regulations may prescribe in terms of penalties, as this may arguably fall within the Third Pillar, as discussed in chapter 3. This means that penalty design and enforcement would also likely be delegated to Member States. Even if Regulations were to streamline the sources of laws in EU securities regulation and minimise the *selector* problem, that alone is not quite sufficient to attain the kind of cybernetic system that could result in regulatory convergence. This chapter thus proceeds to investigate what the cybernetic model may suggest in terms of systemic and structural reform that may have to take place at the EU level to achieve regulatory convergence.

## **2. Institutionalisation to Minimise *Selector* Problem**

First, the institutionalisation of a unifying set of rules and norms may minimise the fragmentation caused by a multitude of *selectors*. However, such rules and norms would have to pertain to all four aspects of regulatory convergence.

In terms of sources of laws, it would perhaps be more in line with a cybernetic system that EU securities laws are enacted as Regulations, so that the source of laws becomes centralised. However, accepting things as they are, it has been argued in chapter 2 that lower level laws such as Commission legislation and CESR's soft law are possibly unable to provide sufficient control over the fragmentation that could be allowed by the Directives. This is unless CESR's soft law may be given a more enhanced status to direct towards regulatory convergence. CESR's soft law deals with many details in the Directives, and directly affects the law in action, i.e. the interpretation, administration and possibly enforcement of laws. If national regulators could be persuaded to adopt these unifying norms in law in action, then the gaps in the law in books could *practically* be closed. However, enhancing the status of CESR's soft law requires institutionalisation of the guidelines and recommendations set by CESR. It also requires that CESR's status be made more prominent and stable, so that it can continue to provide expertise in designing such guidelines and norms for regulatory convergence. Such institutionalisation requires political decision and policy affirmation. One of the steps that could be taken at the policy level is to form an organisation to institutionalise CESR's soft law.

### ***2.1 Organisation as Necessary to Embody Institutionalisation of EU Securities Regulation***

How does an institution arise? From the perspective of economics, entrenched patterns of exchange based on efficiency may account for institutions;<sup>3</sup> and from the perspective of political science, certain entrenched patterns of relational structures may become institutions.<sup>4</sup> In anthropological perspectives, many institutions arise through the gradual entrenchment of culture, artefacts and symbols.<sup>5</sup> Therefore, institutions need a process of entrenchment and development.

Institutions can exist apart from the outfit of a formal organisation.<sup>6</sup> Studies have shown that organisations themselves may only be ceremonial or used as instruments, and thus, it is not the organisational outfit that matters but the substance of institutionalisation.<sup>7</sup> If ideological congruence is found amongst disparate agencies, then all the relevant actors could still behave within that ideological congruence and carry out actions that lead to systematic convergence within the institution. Ideological congruence is necessary for a system of regulatory convergence in EU securities regulation.

One such congruent ideology may be that of the “economic constitution” for the EU.<sup>8</sup> However, as discussed in chapter 2, this is a controversial concept to many and would not be readily accepted as a common ideology in the EU. Furthermore, not only academics disagree about whether there is an economic constitution, industry and markets behave with

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<sup>3</sup> New institutional economics is basically associated with the work of Oliver Williamson expounding on Coase’s theory of the firm. See O Williamson, “The Institutions of Governance” (1998) 88 *American Economic Review* 75.

<sup>4</sup> For example, there is some suggestion that “regimes” which are networks of political interests resolving common issues or problems, may produce a relatively stable institution. See R Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (New Jersey: Princeton University Press 1984).

<sup>5</sup> Scott, *Institutions* (2001) op cit at n1 at 71ff.

<sup>6</sup> An organisational structure could be understood as the Weberian type of organisation or bureaucracy, that it is an expanse of internal development and qualitative expansion of tasks, performed by division of labour, under objective governing criteria. See WG Runcken (ed), *Weber: Selections in Translations* (translated by Eric Matthews) (Cambridge: Cambridge University Press 1978) at 348.

<sup>7</sup> Walter W Powell and Paul J DiMaggio, (eds), *The New Institutionalism in Organisational Analysis* (Chicago: University of Chicago Press 1991), generally presents a variety of views of institutionalism, which is a theory beyond the concept of mere organisation in the Weberian sense.

<sup>8</sup> See Part 2.4.4, chapter 2.

ambivalence towards the congruence of the Internal Market ideology as well,<sup>9</sup> demonstrating a lack of “legal consciousness” for the economic constitution. “Legal consciousness” is the empirical observation of how closely compliant actors are, within a regulatory system, with the rules. If the economic constitution is really regarded as a constitution, then the behaviour of Member States would reflect the importance of the Internal market.<sup>10</sup> On a wider landscape, very few pan-EU bank mergers have taken place, and in fact regulators in Spain and Italy have taken steps to prevent the acquisition of a domestic champion by other European corporations. Significant takeovers and mergers in the mainland EU are regarded with much scepticism and resistance.<sup>11</sup> This is in spite of the Single Market programme having gone on since 1992.<sup>12</sup> As such, there is insufficient EU-wide “legal consciousness” of the economic constitution, and it is yet too early to rely on the economic constitution as providing the institutional ideology for EU securities regulation.

Since there is an insufficiently strong “legal consciousness” of the economic constitution ideology in the EU, one may not be able to rely on ideological congruence itself to provide for the institutionalisation of regulatory convergence in EU securities regulation. It is argued that the dedication of an organisation to institutionalise regulatory convergence, is perhaps necessary in the EU.

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<sup>9</sup> See Editorial Comment, “The Challenge of Financial Integration” (Financial Times 31 March 2005).

<sup>10</sup> “Consciousness” is increasingly being studied in terms of regulatory compliance, and different environments of regulation can shape different degrees of consciousness, and such consciousness may affect regulatory effectiveness. See Erik W Larson, “Institutionalising Legal Consciousness: Regulation and the Embedding of Market Participants in the Securities Industry in Ghana and Fiji” (2004) 38 Law and Society Review 737 where a study was carried out regarding the enforcement environment of securities regulation in Ghana and Fiji. Larson found that where the regulation was “close to the market” and robust in Fiji, a formal legal consciousness complying with the rules arose. But in Ghana where the regulation was more distantly carried out, the “legal consciousness” was more quasi-legal and compliance was with the floor trading norms instituted by brokers themselves. There may be some lessons for the EU in institutionalising the consciousness of the Internal Market for each Member State.

<sup>11</sup> For example, Italian Enel’s bid for Suez of France, see “Enel Board Indicates Battle for Suez not Over Yet”, *Financial Times* (9 March 2006); German Eon’s takeover bid for Spain’s power company Endesa, see “Brussels Confronts Spain over Endesa Move” *Financial Times* (7 March 2006); Polish opposition to Italian merger with its Bank Pekao, see “Polish Government Isolated in Opposition to Pekao-BPH Merger”, *Financial Times* (10 March 2006).

<sup>12</sup> The Single European Act 1992.

Although new institutional economics may be used to argue that an organisation may evolve from an institution, and not the other way round,<sup>13</sup> the weak institutionalisation of regulatory convergence in EU securities regulation may not be relied upon to give rise to spontaneous organisation in the form of a cybernetic system for regulatory convergence. North defines an organisation as an agent that could perpetuate the institutional framework, as organisations are creations of purpose.<sup>14</sup> It may seem that the imposition of an organisation may be crucial to establishing the direction for institutionalisation of regulatory convergence in EU securities regulation. Mitchell argued that organisations have the qualities of “intentionality” to bring about structural entrenchment of rules and norms, by virtue of a system of hierarchy and command.<sup>15</sup> The formality of an organisation provides for the structure to execute the intentionality to achieve certain objectives, and thus, organisation may be crucial to establishing a cybernetic system to institutionalise regulatory convergence in EU securities regulation.

An organisation provides dedicated individuals to achieve the objective of regulatory convergence.<sup>16</sup> Although institutionalisation need not always be top-down<sup>17</sup> and is not necessarily formalised through organisation,<sup>18</sup> the benefits of organisation as put forward by classical organisation theory would help achieve the institutionalisation of EU securities regulation.

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<sup>13</sup> Oliver E. Williamson, "The New Institutional Economics: Taking Stock, Looking Ahead" (2000) 38 *Journal of Economic Literature* 595.

<sup>14</sup> Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press 1990).

<sup>15</sup> Lawrence E. Mitchell, "Structure as an Independent Variable in Assessing Stock Market Failures" (2004) 72 *George Washington Law Review* 547.

<sup>16</sup> Institutions are defined as organised designs run by purposeful people. See M Egeberg, "Designing Public Organisations" in J. Kooiman and K.A. Eliassen (eds), *Managing Public Organisations* (London Sage 1987) at 142. Even if one takes a new institutionalist view, that organisations act as agents for institutionalism to be perpetuated, organisations are the necessary infrastructure for institutionalisation. See Walter Powell and Paul DiMaggio (eds), *The New Institutionalism* (1991) op cit at n7, reviewed by David H Kamens, (1993) 98 *American Journal of Sociology* 1493. New Institutionalism seems to be an offshoot of organisation theory, and explores the value systems that underpin organisations. Two main schools of thought are the Eastern School suggesting that organisational internal arrangements affect institutionalisation, but the Western suggests external influences affect institutionalisation and organisational features, by isomorphic influences.

<sup>17</sup> Geoffrey M Hodgson, "The Evolution of Institutions" (2002) 13 *Constitutional Political Economy* 111.

<sup>18</sup> Oran A Young, "International Regimes: Towards a New Theory of Institutions" (1986) 39 *World Politics* 104.



The idea of an organisation is based on the Weberian bureaucracy, and not a consociational model such as a regime or network. As discussed earlier, consociational forces are practical in nature and not based on ideology. As institutionalisation needs a congruent ideology to establish the EU securities regulation system, it is believed that consociational influences would not be sufficient. Although Weber's work and subsequently Parsons' work, may be regarded as emanating from the old days of "grand theory",<sup>19</sup> where academics sought a grand framework to encompass many strands of thought, this thesis is not arguing that such grand theory is advocated here to support a panacea of sorts for regulatory convergence. Rather, the elements discussed in these grand theories may still provide useful features for organisational design in order to harness the potential of organisations as institutional frameworks.

Classical organisations theory began with the work of Weber, and identifies two main benefits. The first, sophistication and effective administration,<sup>20</sup> and the second, efficient administration.<sup>21</sup> Sophistication and effectiveness is brought about by the technocratic expertise of the bureaucracy, effectiveness by division of labour, and efficiency mainly brought about by the hierarchical structure which determines how internal conflict may be ordered.<sup>22</sup> Parsons then espoused a grand theory of the functional organisation, and elaborates on organisational features that would create a cybernetic systemic structure to attain organisational objectives.

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<sup>19</sup> See for example, Talcott Parsons who tried to assimilate Durkheim, Weber and Pareto's works into a grand theory of social action, in *The Structure of Social Action* (NY: McGraw-Hill 1937, Rep The Free Press, 1968). Although criticised as being too idealistic and ignoring problematic features in society, see Robert J Holton and Bryan S Turner, *Talcott Parsons on Economy and Society* (London: Routledge, 1986), some commentators agree that some features of Parsons' work remain useful.

<sup>20</sup> Weber argues that a bureaucratic organisation is its "purely technical superiority over every other form" and provides "precision, dispatch, clarity and familiarity with documents, continuity and discretion, uniformity, rigid subordination, savings in friction in material and personal costs". See WG Runchken, *Weber* (1978), op cit at n6 at 350.

<sup>21</sup> Weber was of the view that "work organised on a collegiate basis gives rise to friction, delay and compromise", Runchken, ibid at 351.

<sup>22</sup> The pervasiveness of Weberian analysis is affirmed in Clifford I Nass, "Bureaucracy, Technical Expertise and Professionals: A Weberian Approach" (1986) 4 Sociological Theory 61.

Talcott Parsons<sup>23</sup> has developed organisational theory into a model of four functional imperatives for an organisation to survive. The four imperatives are adaptation, goal attainment, internal integration and latency (i.e. acts that supply actors with motivation). Goals define the orientation of an organisation, and sustain an organisation. However, an organisation is also sustained by its capacity to adapt, its latent potential to motivate actors to continue affirming its goals and activities, and its cohesive internal arrangements. An organisation allows three levels of management to be carried out to achieve its objectives. First, an organisation is managed at an *institutional* level to ensure that goals and values are entrenched, and that their plausibility is accepted. The *institutional* level of management also allows an organisation to adapt to external changes. This level also corresponds to a “policy level” type of decision-making in the organisation.<sup>24</sup> Next, the organisation is managed at a *managerial* level to ensure internal cohesiveness in achieving the goals and that relevant actors are motivated to achieve those goals. This is also referred to as the coordinative function of the organisation.<sup>25</sup> The managerial level also provides allocative decisions for the organisation in terms of allocating resources to different parts of the organisation.<sup>26</sup> Finally, an organisation is managed at a *technical* level to operationally achieve the goals. This grand theory of organisation, based on functional sociology, posits that organisations are meant to perform functions, and that each part has a functional significance, constituting an entire system. The value of the classical theory remains significant today.<sup>27</sup> The theory shows that the functional organisation can be designed to provide a system of control to administer and achieve a goal like regulatory convergence.

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<sup>23</sup> T Parsons, “Some Ingredients of a General Theory of Formal Organisation” in Parsons, *Structure and Process in Modern Societies* (NY: The Free Press 1960) at 59.

<sup>24</sup> Also analysed in T Parsons, “A Sociological Approach to the Theory of Organisation” in Parsons, *Structure and Process*, *ibid*, at 16.

<sup>25</sup> *Ibid*.

<sup>26</sup> *ibid*.

<sup>27</sup> Modern critics question whether internal cohesiveness can ever be achieved (P Selznick, “Foundations of the Theory of Organisation” (1948) 13 *American Sociological Review* 25) and whether organisations can maintain closed boundaries vis a vis others. Postmodernists question whether there can be a theory of organisation at all, is it a fiction of language, and how sociologists ought to approach the idea of “organisation”. See discussion in John Hassard, *Sociological and Organisation Theory* (Cambridge: Cambridge University Press 1993).

Some empirical studies done on organised bureaucracies, such as by Francis E Rourke,<sup>28</sup> have corroborated Weber's earlier thesis on the benefits of an organised system of bureaucracy to attain certain goals. The major benefit of an organised bureaucracy is that the organisation develops expertise in the issue area it is responsible for. Such expertise is developed at the "advisory" level, i.e. the level of policy-making, and the "discretion" level, which refers to administration and operation. Thus, an organisation is able to provide coherent direction and practical administration over a special issue area. An organised bureaucracy is also able to develop organisational characteristics<sup>29</sup> i.e. its hierarchies, rules and norms, routines, concentration and division of labour and segmentation of large problems into solvable parts. The skills of its members may also provide well-planned solutions in a systematic fashion. Thus, tasks could be designed, and performed with efficiency and effectiveness towards attainment of the organisational goals. The organisation of an agency responsible for EU securities regulation would seem to be an apt way to institutionalise regulatory convergence for EU securities regulation. Such an agency may develop both the advisory and discretion competencies as described above, making it a fully fledged regulatory institution for EU securities regulation.

Etzioni also describes how the organisational outfit facilitates the use of power to control the cohesiveness of the organisation.<sup>30</sup> Thus, the organisational outfit provides an appropriate infrastructure for institutionalisation to take place. It is also arguable that dedicated

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<sup>28</sup> *Bureaucracy, Politics and Public Policy* (Boston: Little Brown and Co., 1969).

<sup>29</sup> Barbara Koremenos, Charles Lipson and Duncan Snidal, "The Rational Design of International Institutions" in *Rational Design of International Institutions* (Cambridge: Cambridge University Press 2003) at 1. See also generally, Robert E Goodin (ed), *Theory of Institutional Design* (Cambridge: Cambridge University Press 1996).

<sup>30</sup> A Etzioni, *Comparative Analysis of Complex Organisations* (New York: Free Press 1975); Zucker, "The Role of Institutionalism in Cultural Persistence" (1977) op cit at n2.

organisations that serve the purpose of institutionalisation have always served EU integration well and are the chief means of providing for the EU, solutions in particular areas.<sup>31</sup>

It has been criticised<sup>32</sup> that structured organisations after Weberian bureaucracies may provide orderly solutions, but they are limited by their boundedness. Boundedness means that there are limitations to the level of “perfect knowledge” needed to achieve organisational goals, and the organisation can become rather inward-looking. Furthermore, various units in the organisation may be further “bounded” in their decision-making. Such an organisation is likely to become static and unresponsive. Having a dedicated EU organisation to deal with EU securities regulation may cause the development of EU securities regulation to become stunted, and be insensitive to Member States’ needs. However, it is possible to define the scope of the organisation’s remit, and adjust the internal structuring of an organisation to become more organismic, so that it may be cognisant of changing conditions and respond organically.<sup>33</sup> This argument does not rebut the usefulness of organisations *per se* but serves to warn about what internal structures can do to affect organisational effectiveness. Thus, it is submitted that the critique does not negate the argument for the organisation.

Furthermore, institutionalisation does not automatically take place with the organisation being put in place. It takes time for the organisation to entrench its goals and values, and occupy a convincing *regulatory* position in the interactive dynamics with other actors in the regulatory landscape.<sup>34</sup> Long term interaction is necessary for the organisation to be regarded

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<sup>31</sup> Brigid Laffan, “Becoming a Living Institution” (1999) 37 JCMS 251. Egeberg, “Designing” (1987) *op cit* at n16 at 142.

<sup>32</sup> T Burns, “Mechanistic and Organismic Structures” in D.S Pugh (ed), *Organisational Theory* (London: Penguin Books 1990, 3<sup>rd</sup> ed) at 64ff.

<sup>33</sup> Structuring is discussed in J.D. Thompson, “The Structure of Complex Organisation” in Pugh (ed), *Organisational Theory* (1990), *ibid* at 29ff.

<sup>34</sup> The idea of a regulatory landscape or “space” is argued by Colin Scott who opines that regulation is inherently divided amongst many actors of influence as different actors have different resources and spheres of action. See “Analysing Regulatory Space: Fragmented Resources And Institutional Design” (2001) Public Law 329.

as an institution.<sup>35</sup> However, organisational permanence may arguably be necessary to precede the institutionalisation of regulatory convergence in EU securities regulation.

The following two parts argue that the organisation of an EU securities agency may also be supported from perspectives in economics and integration theory in political science.

## *2.2 Economic Justifications for Organising an EU Securities Regulatory Agency*

There are economically sound reasons for organising an EU securities regulation agency. The economic reasons for private institutions such as the firm, were put forward most prominently in Coase's seminal work, "The Theory of the Firm"<sup>36</sup> which reasoned that the existence of a firm is to internalise contractual arrangements which would otherwise have been achieved in the open market. The internalisation is carried out because it lowers transaction costs for the entrepreneur and is therefore in the interests of efficiency. This theory could also be adapted to justify the existence of public bureaus and regulatory organisations. Without regulatory organisations, disparate arrangements of contracting within government departments and with external actors would be relied on to provide regulatory goods. The institution of public bureaus may be seen as a cost-effective way to perform certain public functions coherently and on a continuing basis.<sup>37</sup>

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<sup>35</sup> Paul Willman, David Coen, David Currie and Martin Siner, "The Evolution of Regulatory Relationships, Regulatory Institutions and Firm Behaviour in Privatised Industries" (2003) 12(1) *Industrial and Corporate Change* 69. See also Mary Jo Hatch and Majken Schultz, "The Dynamics of Organisational Identity" in Mary Jo Hatch and Majken Schultz eds, *Organisational Identity* (Oxford: Oxford University Press 2005) at 377 which explains how long term interactional relations between the internal dynamics and external relations of an organisation produce an "identity", which may be useful to institutionalisation.

<sup>36</sup> (1937) 4 *Economica* 486.

<sup>37</sup> Argued in Terry M Moe, "The New Economics of Organisation" (1984) 28 *American Journal of Political Science* 739 who adapted Coase's work and the economics surrounding bounded rationality to the analysis for the existence of public bureaus. Behavioural theorists who support rationality underlying human choices also support the economic justifications for organising. See Douglas North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press 1990). This line of thought, although applied to private firms, may be applied to public organisations as public organisations may also be underpinned by rational behaviour on the part of responsible actors. See Marshall M. Meyer, "The Growth of Private and Public Bureaucracies" (1987) 16 *Theory and Society* 215. However, it is noted that public bureaus may not exclusively take care of every regulatory function, and some aspects may be contracted out or privatised if it is more

Transaction-cost efficiency does not mean that all national regulators need to be centralised into an EU agency and cease to exist as national regulators. On the contrary, the EU agency can be tasked to deal specifically with convergence in the aspects of securities regulation that have a pan-EU element, and deal with cross-border issues. Other studies based in the US have found that the existence of a dedicated organisation at a central or federal level to deal with particular issue areas that have multi-state effects, have produced enhanced effectiveness in dealing with those areas.<sup>38</sup>

A comprehensive set of arguments advanced in favour of an EU agency for EU securities regulation may be found in Yannis V Avgerinos' paper "EU Financial Market Supervision Revisited- The European Securities Regulator".<sup>39</sup> Avgerinos identifies other reasons for institutionalising a centralised EU securities agency, including reduction of institutional and compliance cost in centralising EU securities regulation, reduction of agency costs (as multiple sets of national regulators may multiply agency costs), as well as rationale based on economic facts such as the rise of pan-European entities in securities intermediaries and exchanges and the need for pan-European regulation, improved pan-European decision-making and crisis management, and more cohesive representation in international fora. However, Avgerinos' arguments are directed towards the substitution of national agencies by an EU securities regulation institution, and thus, the cost-benefit analyses done in that paper are towards that end. This thesis however argues that there is a need for an EU level institution in order to direct towards regulatory convergence in EU securities regulation, but

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transaction-cost effective to do so. See Jody Freeman, "Private Parties, Public Functions And The New Administrative Law" (2000) 52 *Administrative Law Review* 813; Mark R Freedland, "Government By Contract And Public Law" (1994) *Public Law* 86; Sidney A Shapiro, "Outsourcing Government Regulation" (2003) 53 *Duke Law Journal* 389; Peter Vincent-Jones, *The New Public Contracting: Regulation, Responsiveness, Relationality* (Oxford: Oxford University Press 2006).

<sup>38</sup> B Dan Wood, "Federalism and Policy Responsiveness: The Clean Air Case" (1991) 53 *Journal of Politics* 851. Terry M Moe, "Control and Feedback in Economic Regulation: The Case of the NLRB" (1985) 78 *American Political Science Review* 1094.

<sup>39</sup> Jean Monnet Working Paper 7/03 (New York University School of Law 2003).

that institution need not replace national securities regulators as such. The different roles of each can be defined. This will be discussed later.

A general critique against economic justifications is that many things are not susceptible of being represented as quantifiable costs.<sup>40</sup> The cost of regulation itself is often difficult to establish, as it is impossible to put a market value on demand for public goods.<sup>41</sup> Even if there may be transaction costs in multiple regulator transactions, these costs have to be weighed against the cost of setting up an organisation to institutionalise regulatory convergence. Organisations are expensive, and certain behavioural weaknesses may multiply cost. For example, organisations have been criticised as being focused on perpetuating their own ceremonial outfit to prove that decisions have been made, by appearing to organise extensively and generating paperwork, while the goals are still not achieved.<sup>42</sup> However, this thesis argues that even if transaction costs may not be exactly quantifiable, and there are costs of setting up and maintaining an organisation, a cost-benefit exercise could be a useful prelude to the *design* of the organisation, but need not negate the arguments for the organisation.

Finally, from a historical perspective, the EU itself has relied heavily on organisations to institutionalise various integration processes in the EU.<sup>43</sup> It is acknowledged that organisations are facilitative of the integration process.<sup>44</sup> Such organisations also have the benefit of being removed from Member States and attaining a “European character” and

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<sup>40</sup> M Chapman and PJ Buckley, “Markets, Transaction Costs, Economists and Social Anthropologists” in JG Carrier (ed), *The Meaning of the Market* (Oxford: Berg 1997) at 225ff.

<sup>41</sup> C Goodhart et al, *Financial Regulation* (London: Routledge 1998). See also “The Regulator’s Best Friend” *The Economist* (31 March 2005) discussing the limitations of economic cost-benefit approaches.

<sup>42</sup> Walter W Powell, “The Institutionalisation of Rational Organisation” (1985) 18 *Contemporary Sociology* 564; Powell and DiMaggio (eds), *The New Institutionalism* (1991), op cit at n7 and Meyer, “The Growth of Private and Public Bureaucracies” (1987), op cit at n37; Marshall W Meyer and Richard Scott, *Organisational Environments: Ritual and Rationality* (Beverly Hills CA: Sage 1983).

<sup>43</sup> The Council of Ministers for policy-making; the European Commission as an executive body to initiate legislation and execute policy, and the Courts to secure European jurisprudence are examples of organisations institutionalising structures at the highest levels of integrating the European political framework.

<sup>44</sup> Laffan, “Becoming a Living Institution” (1999), op cit at n31. See also Johan P Olsen, “Reforming European Institutions of Governance” (2002) 40 *JCMS* 581, where institutionalisation as a way of integration is affirmed.

autonomy which allows it to serve EU wide perspectives.<sup>45</sup> An organisation without institutionalisation relies on power for effective governance<sup>46</sup> and voluntary compliance,<sup>47</sup> and is merely a regime-type arrangement which can be transient if participants express preference changes.<sup>48</sup> An institution without an organisation may be self-sustaining as a set of norms that could permanently constitute some form of order, but that takes a long time to evolve. It therefore appears that, in the context of the EU, organisations are widely used to secure entrenchment of an integration agenda in an efficient way, and their benefits are recognised. An organisation to provide the necessary institutionalisation is arguably apt for regulatory convergence in EU securities regulation.

### *2.3 Justifications for An Organisation from the Perspective of Political Science*

Organisation and institutionalisation of a dedicated EU securities regulatory agency may be an issue of political concern. This is because the balance of EU competence and national competence has always been a political issue, and the concepts of subsidiarity and proportionality may require that, since there are competent national regulators to carry out the administration of securities regulation, the administration should not be moved to the EU level.<sup>49</sup> Neuman for instance describes subsidiarity as embodying “self-determination and accountability, political liberty, flexibility, preservation of identities, diversity, and respect for internal divisions of component states, plus the possible value--if it counts as a value per

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<sup>45</sup> T.Christiansen, "Intra-institutional Politics and Inter-institutional Relations in the EU: Towards Coherent Governance?"; (2001) 8 JEPP 747.

<sup>46</sup> D North, "Institutions Matter" (1994), quoted in Bruno Amable, "Institutional Complementarity and Diversity of Social Systems of Innovation and Production" (2000) 7 Review of International Political Economy 645 at 653.

<sup>47</sup> K.J. Holsti, "Governance Without Government: Polyarchy in 19<sup>th</sup> Century European International Politics" in James N Rosenau and Ernst-Otto Czempiel (eds), *Governance Without Government* (Cambridge: Cambridge University Press 1992, rep 2000) at 30.

<sup>48</sup> George Downs, Kyle Danish and Peter Barsoom, "The Transformational Model of International Regime Design: Triumph of Hope or Experience" (2000) 38 Columbia Journal of Transnational Law 465.

<sup>49</sup> For a general discussion of the principles of subsidiarity and proportionality, see A Arnall at al, *Wyatt and Dashwood* (London: Sweet & Maxwell 2003).



se- of deregulation".<sup>50</sup> Subsidiarity is the principle that attempts to balance the forces of supranationalism and inter-governmentalism in the EU.<sup>51</sup> Subsidiarity may also be used to limit the creation of EU agencies.<sup>52</sup> However, subsidiarity itself is capable of being interpreted to limit, as well as allow EU level action to be taken.

The Protocol to the Amsterdam Treaty provides guidelines for when Community action is necessary, such as where there are economies of scale and cross-border effects.<sup>53</sup> Thus, where Community level action can be justified on those guidelines, such Community level actions are arguably as justified by subsidiarity as deregulation may be so justified. A similar argument applies for proportionality. Existing literature often interprets proportionality as limiting EU level action to that which is appropriate and necessary,<sup>54</sup> but where EU level action is necessary in order to achieve cross-border regulation and integrative effects, can proportionality not be argued to support the opposite of limited action, i.e. a high level of convergence? Subsidiarity and proportionality can be used to justify institution-building in the EU, as institutions may be necessary to ensure that law in books achieve the desired effects in action in order to complete the Internal Market.<sup>55</sup>

As the organisation of an EU securities regulatory agency could be seen as an act of power shift towards supranationalism, the following discusses the likelihood of political opposition from various integration theories.

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<sup>50</sup> Gerard Neuman, "Subsidiarity, Harmonisation and their Values: Convergence and Divergence in Europe and the US" (1996) 2 Columbia Journal of European Law 573.

<sup>51</sup> An overview of various political science governance models including liberal intergovernmentalism, neofunctionalism and multi-level governance, is provided in Paul Craig, "The Nature of the Community: Integration, Democracy and Legitimacy" in Craig and de Búrca (eds), *The Evolution* (Oxford: OUP 1999).

<sup>52</sup> Case 9/56, *Meroni & Co., Industrie Metallurgiche, SpA v High Authority of the European Coal and Steel Community* [1958] ECR 133.

<sup>53</sup> Article 5 to the Protocol on the Application of the Principles of Subsidiarity and Proportionality, Treaty of Amsterdam 1997.

<sup>54</sup> Phil Sypris, "Legitimising European Governance: Taking Subsidiarity Seriously with the Open Method of Coordination". EUI Working Paper 2002/10, (Florence: European University Institute, 2002).

<sup>55</sup> Stephen Weatherill, *Law and Integration in the European Union* (Oxford: Clarendon 1995) at 18 and 286.

Taking a neo-realist view of states, that states are essentially defensive of their own self interests and are reluctant to make themselves vulnerable by relating to each other, a power shift towards supranationalism may be objectionable. However, the fact is that there is increasing cross-border securities activity,<sup>56</sup> and thus, a certain amount of inter-dependence between Member States. As such, Member States may prefer to establish institutions that would mediate these interests in a framework of rules and norms that facilitate predictable behaviour. This is the neoliberal institutionalist view of international relations, which could be used to support the establishment of the organisation for EU securities regulation. The purely neofunctionalist view<sup>57</sup> of international relations also supports the establishment of an EU agency for securities regulation which would allow state or substate actors to cooperate in order to solve particular technocratic and functional issues in a rational manner.

However, it may be argued that the organisation of an EU securities agency is inappropriate in the light of more dynamic forms of EU governance which are less supranational in nature. These dynamic forms of EU governance allow cooperation between diverse actors without the need for formal organisation. Some recent views are Blank, Hooghe and Marks' view of multi-level governance<sup>58</sup> and Armstrong and Bulmer's new institutionalism<sup>59</sup> (based on March and Olsen's view that institutions are a collective arrangement of rules and agreements that have "cemented" to produce an overall identity).<sup>60</sup>

Blank, Hooghe and Marks argue that EU governance is a multi-level kind where many interactive layers of supranational, state and substate actors play a part in constituting the

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<sup>56</sup> European Commission, *Financial Integration Monitor 2004*, SEC (2004) 559.

<sup>57</sup> Olsen. "Reforming" (2002), op cit at n44.

<sup>58</sup> Liesbet Hooghe and Gary Marks, "Types of Multi-level Governance" European Integration online Papers (EIoP) Vol. 5 (2001) N° 11 at <http://eiop.or.at/eiop/texte/2001-011a.htm> (accessed March 2006).

<sup>59</sup> Kenneth Armstrong and Simon Bulmer, *The Governance of the Single European Market* (Manchester: Manchester University Press 1998) at 43ff.

<sup>60</sup> J. March and J. Olsen, "The New Institutionalism: The Organisational Factors of Political Life" (1984) 78 *American Political Science Review* 734, and *Rediscovering Institutions: The Organisational Basis of Politics* (New York: Free Press 1989).

governance of an issue area.<sup>61</sup> Thus, it could be argued that if EU governance is inherently diverse, then setting up another organisation may complicate the diverse landscape, and not be effective in directing towards regulatory convergence. Professor Scharpf points out that there are a variety of political relationships or even “games” that may ensue out of multi-level interactions.<sup>62</sup> Each level exerts political influence over other levels to secure governance that may become negotiated, or joint or dominant.<sup>63</sup> Would an EU agency be able to navigate these diverse forces and institute a cybernetic system of regulatory convergence?

However, other theorists who support plural governance have different views. Armstrong and Bulmer argue that economic integration needs policy output to achieve it, and such policy output has to come from institutionalisation at the EU level. Institutionalisation brings about a process whereby political actors are co-opted in the playing out of political forces in the EU. However, the institution is able to direct such forces according to its processes and norms to effect the shaping of a congruent policy. This view may be empirically supported by the use of EU agencies to achieve congruent regulation in different issuer areas.<sup>64</sup>

### 3. Institutionalisation of CESR as an EU Agency

It has thus far been argued that the institutionalisation of CESR’s soft law may provide a unifying set of norms for the interpretation and administration of law, as well as supervision and enforcement, all the aspects of law in action. This is perhaps best achieved by dedicating CESR as an organised agency to such institutionalisation. The minimising of *selector* proliferation in the norms for law in action may provide a form of practical regulatory

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<sup>61</sup> Further elucidations on how multi-level governance actually works may be found in Hooghe and Marks, “Types of Multi-level Governance”, op cit at n58; Fritz Scharpf, “Toward a Theory of Multi-Level Governing in Europe” (2001) 24 *Scandinavian Political Studies* 1.

<sup>62</sup> Fritz Scharpf, *Games Real Actors Play: Actor-Centered Institutionalism in Policy Research* (Boulder: Westview Press 1997).

<sup>63</sup> Scharpf, “Toward a Theory” (2001), op cit at n61.

<sup>64</sup> Jonas Tallberg, “Delegation to Supranational Institutions: Why, How, and with What Consequences?” (2002) 25 *West European Politics* 23; Laffan, “Becoming” (1999) at n31 and Olsen, “Reforming” (2002), op cit at n44.

convergence in spite of the fragmentation that could entail from the Directives and multiversalism<sup>65</sup> in national laws. In sum, this would mean that CESR would have to become an EU agency whose recommendations and guidelines have to be endowed with a regulatory status.<sup>66</sup>

The rise of regulatory agencies in the EU has not been viewed with ease. The classic case of *Meroni*<sup>67</sup> lays down the limits of delegation of powers by the European Commission to agencies in the exercise of the Commission's executive functions for the EU. Regulatory agencies are not prohibited by the Treaty of Rome as the Commission may reasonably be expected to delegate regulatory powers in order to achieve effective exercise of the powers. However, this is subject to the delegation not disturbing the institutional balance in the EU. Just as separation of powers is the constitutional capstone of nation states, institutional balance is the capstone of a mixed polity such as the EU.<sup>68</sup>

Institutional balance has been used by critics to argue against institution of new agencies.<sup>69</sup> However, agency creation has largely been justified in order to execute legislative acts.<sup>70</sup> The characteristics of technocratic functionality, efficiency and independence from politicisation also give agencies credibility in their commitment to the goals of the agency.<sup>71</sup> The White

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<sup>65</sup> discussed in chapter 2, Part 2.2.

<sup>66</sup> Renaud Dehousse, Christian Joerges, Giandomenico Majone and Francis Snyder, with Michelle Everson, "Europe After 1992- New Regulatory Strategies" EUI Working Paper LAW No. 92/31 (Florence: European University Institute 1992).

<sup>67</sup> *Meroni and Co Industrie Metallurgiche, SpA v High Authority of the ECSC*, Case 9/56, [1958] ECR 133.

<sup>68</sup> Giandomenico Majone, "Delegation of Regulatory Powers in a Mixed Polity" (2002) 8 ELJ 319.

<sup>69</sup> See discussion in Koen Lenaerts, "Regulating the Regulatory Process" (1993) 18 ELR 23.

<sup>70</sup> *ibid.*

<sup>71</sup> G Majone, *Regulating Europe* (London: Routledge 1998), "Delegation of Regulatory Powers" (2002), *op cit* at n68. However, empirical studies into some independent European agencies may show that this independence differs in extent from agency to agency. Agency drift causes some principal control to be maintained, either through "fire alarm" processes, patrolling devices or ex ante procedural measures such as control over appointments and decision-making. The nature of the regulatory role, such as ex ante or ex post regulation affects independence, as ex ante regulation gives an agency greater say in setting the agenda. The political history of the creation of the agency, and the type of technocratic functions also affect agency independence. See Sebastian Krapohl, "Credible Commitment in Non-Independent Regulatory Agencies: A Comparative Analysis of the European Agencies for Pharmaceuticals and Foodstuffs" (2004) 10 ELJ 518.

Paper on Commission Organisation issued after the resignation of the Santer Commission<sup>72</sup> also emphasised the need for the Commission to concentrate on developing core competencies such as policy development and enforcement, and to delegate more technical functions to agencies.<sup>73</sup> There has been a wave of intense agency creation in the EU shortly after.<sup>74</sup> The creation of an EU securities agency is not likely to upset institutional balance as the Commission already has competence in the Internal Market and may delegate securities regulation to an agency. This thesis suggests that this agency need not replace all national securities regulators, as has been argued elsewhere.<sup>75</sup> The agency is arguably essential to secure the regulatory convergence desired for the completion of the Single securities market, and such agencification could arguably be designed to be in line with proportionality.

The creation of a securities regulatory agency would also likely be subject to the harshest critics from the arguments of accountability and democratic deficit.<sup>76</sup> However, many commentators are of the view that those critiques go more towards the design of the organisation, rather than the negation of the agency itself.<sup>77</sup> The relationship between agencification and the issues of democratic deficit and legitimacy will be discussed later.

### 3.1 CESR's role

This thesis suggests that the most appropriate organisation to be instituted as an agency is CESR. CESR could focus on pan-European aspects of securities regulation such as matters

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<sup>72</sup> *Designing Tomorrow's Commission: A Review of the Commission Organisation and Operations*, 7 July 1999.

<sup>73</sup> A discussion can be found in Paul Craig, "The Fall and Renewal of the Commission: Accountability, Contract and Administrative Organisation" (2000) 6 ELJ 98.

<sup>74</sup> R Daniel Kelemen, "The Politics of Eurocratic Structure and the New European Agencies" (2002) 25 West European Politics 93.

<sup>75</sup> n39.

<sup>76</sup> Michelle Everson, "Independent Agencies: Hierarchy Beaters?" (1995) 1 ELJ 180 and Martin Shapiro, "The Problems of Independent Agencies in the United States and the European Union" (1997) 4 JEPP 276.

<sup>77</sup> Renaud Dehousse, "Regulation by Networks" (1997) 4 JEPP 246, G Majone, "Delegation of Regulatory Powers" (2002) op cit at n71, and Matthew Flinders, "Distributed Public Governance in the EU" (2004) 11 JEPP 520, in which "design" issues such as the empowerment of the agency, coordination with other agencies, accountability are advocated to be carefully fleshed out.

that pertain to pan-EU issues, foreign issuers and cross-border issues, as those areas are where regulatory convergence would be most relevant. National regulators could have primary competence over purely national matters, as it may not be efficient or effective to remove national matters for management at the EU level. Such management would be too removed from the beneficiaries of the regulation,<sup>78</sup> and would be utilising EU resources to subsidise a purely national matter. This proposed framework would seem to meet the requirements of a cybernetic system, and would also leverage on both the expertise and functions of CESR and national regulators. The arguments in support are derived from comparisons made with two other models of EU level policy/regulation that involve an EU agency and national counterparts. These are the Competition regulation model and the European System of Central Banks (“ESCB”).

The thesis is of the view that the Competition Regulation model and the ESCB have centralised to a large extent, norm-selection, and created institutions of EU level regulation. They serve as models for the discussion on CESR as a European securities agency. However, due to space constraints, it is not possible for this thesis to delve into a detailed comparative analysis of the framework and structures of the Competition regulation model and the ESCB to ascertain the cybernetic working of each model. The thesis will instead highlight the key feature of both models, ie a large extent of norm-selection that is centralised at the EU level, accompanied by delegated *effectuation* to Member States, to suggest that CESR may adopt that basic framework, and still be able to achieve a cybernetic system for regulatory convergence.

First, the Competition regulation model, is a form of decentralised administration with a significant amount of central control by the Directorate of Competition at the European

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<sup>78</sup> J Dalhuisen, “Toward a Single European Capital Market” in M Andenas and Y Avgerinos (eds), *Financial Markets in Europe- Towards a Single Regulator?* (The Hague: Kluwer Law International 2003) at 35.

Commission. This model allows a central agency to be responsible for directing the *selection* of norms while the *effectuation* is delegated to national regulators. However, there is also some room for national regulators to become *selectors* although the Commission has some vertical powers that may control the fragmentation that may arise out of multiple *selectors*. It should be noted however, that competition regulation is a Community activity,<sup>79</sup> thus, the centralisation of control at the EU level has been established very early on, with decentralisation to Member States being a very recent phenomenon. It is not argued here that regulatory convergence in securities regulation amounts to an approximation towards a Community activity. However, as discussed, regulatory convergence requires an EU level system to direct processes toward this goal, and this system may be able to adopt some useful characteristics of organisation found in the decentralised competition regulation of Articles 81 and 82 of the EC Treaty prohibiting anti-competitive undertakings.

The other model is the European System of Central Banks (“ESCB”). This analogy may be less appropriate than the Competition regulation model, as the ESCB is a system that has a particular core economic function in the EU i.e. maintenance of price stability,<sup>80</sup> and has been instituted by Treaty.<sup>81</sup> The ESCB is of an institutional status that is higher than a regulatory agency. Hence, the design of the system warrants high centralisation and very defined delegation to national central banks. The ESCB is a system where the EU agency, the European Central Bank (“ECB”) and the national central banks (“NCBs”) exist together as a System of Central Banks, with clear responsibilities. The ECB however retains control over supervision of the NCBs and policy decisions.<sup>82</sup> It may also intervene in the functions of the NCBs through majority voting in the Governing Council, which is a body comprising of members of the ECB executive board and national central bankers.<sup>83</sup> The ECB and NCBs

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<sup>79</sup> Article 3, E.C. Treaty.

<sup>80</sup> Article 2, Protocol on the Statute of the European System of Central Banks and of the European Central Bank.

<sup>81</sup> Treaty of Maastricht 1992.

<sup>82</sup> Articles 4, 5.3, 7 and 8 of the Protocol in n80.

<sup>83</sup> Article 10 of the Protocol in n80.

function as a unified whole in the System, as the ESCB produces output in the form of weekly and periodic reports as a coherent unit.<sup>84</sup>

### ***Competition Regulation Model***

In competition regulation, much centralisation of regulatory control has taken place under the Director-General of Competition in the European Commission in at least the last 40 years, and the Directorate itself has become known as an agency for competition regulation,<sup>85</sup> often known in short as the European Competition Commission. The Competition Commission oversees anti-competitive and restrictive practices in the EC. Under Articles 81 and 82, the Commission administers the prohibition against anti-competitive practices by setting up a notification system. Agreements of undertakings should be notified to the Commission for exemption. The Commission also oversees the operation of Articles 37 and 90 of the Treaty in respect of state monopolies and monopoly rights. It also has exclusive competence to deal with the issue of state aids, and controls merger activity throughout the EU by vetting applications of concentrations of practices.<sup>86</sup> The Commission's direct involvement in administering legislation has avoided decentralised law in action, and in cybernetic terms, the *selector* process of law-making directly feeds into the *effector*, which is the Commission. Being a single *effector*, the administration and implementation of law is not dispersed among many national authorities. There is thus unity in the *effector* process. The Commission is directly involved in enforcement, and feedback from court jurisprudence directly affects the Commission in its *effector* processes. This system of competition law administration,

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<sup>84</sup> Article 15 of the Protocol in n80, and see Ralph Mehnert-Meland, *Central Bank to the European Union* (The Hague: Kluwer Law International 1995).

<sup>85</sup> Article 83, E.C. Treaty, as administered by the Council, then the Commission, Reg. 17/62 [1962] J.O. 204. Merger control was also vested in the Commission by Council Regulation 4064/89, On the Control of Concentrations Between Undertakings, 1989 O.J. (L 395)1, see comment by Earl Ray Beeman, "The EEC Merger Regulation- Preparing for a Common European Market" (1992) 19 Pepperdine Law Review 589. See also Per Jebsen and Robert Stevens, "Assumptions, Goals and Dominant Undertakings: The Regulation of Competition under Article 86 of the European Union" (1996) 64 AntiTrust Law Journal 443.

<sup>86</sup> Council Regulation 1/2003 of December 16, 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the EC Treaty, O.J. 2003 L1/1.(Hereinafter referred to as "Regulation 1")



supervision and enforcement produces a cybernetic system of convergence in competition regulation in concentrations and merger notifications.

By 2003, the Competition Commission recognised that the workload from notifications was getting too heavy.<sup>87</sup> As the Commission needed to devote resources to policy review and development,<sup>88</sup> exclusive control over notifications was abolished. A new approach was taken to allow national competition authorities, national courts and the Commission to administer Articles 81 and 82 of the Treaty.<sup>89</sup> This is described as a form of decentralisation, and it is submitted that this decentralisation model may present some useful features that could be adopted for the relationship between an EU securities agency and national regulators.

It has been recognised that during the years of centralised notifications under the Competition Commission, there was certainty and uniformity in the administration of anti-competitive supervision and enforcement.<sup>90</sup> For example, the Commission issued block exemptions which provided legal guidance on anti-competitive policies. The centralised development has allowed for the administration of the law to mature, before decentralisation takes place. Many commentators warn that decentralisation could result in inconsistencies in regulatory development and higher costs of compliance for businesses. National courts may not have the expertise to judge competently in the technical area of anti-competitive disputes.<sup>91</sup> However,

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<sup>87</sup> *White Paper on Modernisation of the Rules Implementing Arts 85 and 86 of the E.C. Treaty*, April 28, 1999.

<sup>88</sup> Daniel G Goyder, *EC Competition Law* (New York: Oxford University Press 1993) opines that the Commission is too under-resourced most of the time.

<sup>89</sup> Decentralisation may lead to fragmentation, and does not help in the current emphasis on completing the internal market. However, this move may come down to the Commission's lack of resources. See Alan Riley, "EC Antitrust Modernisation: The Commission Does Very Nicely, Thank you! Parts 1 and 2" (2003) 24 and 24 ECLR 604, 657, respectively.

<sup>90</sup> See James S Venit, "Brave New World: The Modernisation and Decentralisation of Enforcement under Articles 81 and 82 of the Treaty" (2003) 40 CMLR 545, Hans M Gilliams, "Modernisation: From Policy to Practice" (2003) 28 ELR 451, James M Turner, "Mega Mergers: Mega Problems" (2001) 17 American University Law Review 131 where they briefly discussed the benefits of centralisation of merger law.

<sup>91</sup> *Ibid*, and see Goyder, *EC Competition Law* (2003) op cit at n88, at 521ff. See Vincent Power, "Representing Clients After the Modernisation of EC Competition Law" (2003) 14 ICCLR 335 where higher costs of compliance were predicted, and Assimakis P Komninos, "Article 234 EC and National Competition Authorities in the Era of Decentralisation" (2004) 29 ELR 106 where the possibility was raised that national authorities lack competition expertise and may perhaps need to seek ECJ preliminary rulings.

some commentators are of the view that the decentralisation structure does not affect the Commission's importance as there is mandatory dialogue between the national agencies and the Commission.<sup>92</sup>

In terms of relationship between the Commission and national competition agencies, national agencies must apply Articles 81 and 82 of the Treaty, and may impose more severe restrictions than the Treaty threshold. The Commission has parallel powers to administer Articles 81 and 82 as well.<sup>93</sup> However, it is to be noted that before the Commission exercises its powers, it is obligated to consult the Advisory Committee comprising of national competition regulators. The Committee's opinion has to be considered by the Commission, although the Commission makes the final decision with respect to its action. The relationship is characterised by mutual information sharing arrangements, when investigations commence, and the ability of either party to request information from each other in assistance.<sup>94</sup> The Commission may also be consulted at the initiative of the national agency.<sup>95</sup> However, the Commission has a power of pre-emption to start proceedings and relieve the relevant national agency from further action.<sup>96</sup>

Where the relationship with national courts is concerned, the relationship is also characterised by mutual information sharing. The courts may request information from the Commission, and Member States must forward court decisions to the Commission. However, national regulators and the Commission could provide written opinions and even oral observations during the proceedings.<sup>97</sup> These arrangements indicate a relatively horizontal relationship between the Commission, national regulators and the court. The decentralisation process from the Commission arguably weakens the cybernetic links in the regulatory convergence of

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<sup>92</sup> Articles 11 and 12, Regulation 1.

<sup>93</sup> Chapters I-III, Regulation 1.

<sup>94</sup> Articles 11 and 12.

<sup>95</sup> Article 11(5), Regulation 1.

<sup>96</sup> Article 11(6), Regulation 1.

<sup>97</sup> Article 15, Regulation 1.

competition law in concentrations and merger notifications. However, there are features of a vertical relationship between the Commission and national courts and regulators. Between the Commission and national regulators, there is arguably more of a vertical relationship as the Commission's power of pre-emption, and its duty to consult but not necessarily abide by the Advisory Committee's decision in exercising its own powers, seem to suggest a potential to provide control over how anti-competitive regulation should be carried out in the EU.<sup>98</sup> The existence of such control may provide unity in the *effector* process. However, national courts are another entity in the *effector* process, and the Commission can only intervene as *amicus curiae*. National courts could however ask the Commission for interpretive advice, and it seems that this takes place frequently, and so, the Commission practically retains the primary position in *norm-selection*.<sup>99</sup> The relationship between the Commission and national courts is arguably more horizontal but then, judicial independence is a fundamental principle of the rule of law. Hence, it would perhaps be useful to view the court more as a feedback mechanism that could affect the *selector* process in law reform, or the *effector* process undertaken by both the Commission and national authorities, with the Commission retaining considerable control.

### ***Lessons from Competition Regulation***

The decentralised Competition Regulation model has some useful features for regulatory convergence in EU securities regulation. First, it provides some guidance on the division of responsibilities between CESR the EU agency and national regulators. It seems that even after decentralisation, the Commission is keen to retain control over *selection* of regulatory norms although *effectuation* is delegated to national regulators. By analogy, it seems that

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<sup>98</sup> Terry Calvani, "Devolution and Convergence in Competition Enforcement" (2003) 24 ECLR 415, and Katarina Pijetlovic, "Reform of the EC Antitrust Enforcement: Criticism of the New System is Highly Exaggerated" (2004) 25 ECLR 356.

<sup>99</sup> Para 2.5, Annual Report of Competition Policy 2005, at [http://ec.europa.eu/comm/competition/annual\\_reports/2005/en.pdf](http://ec.europa.eu/comm/competition/annual_reports/2005/en.pdf).

CESR's soft law may need to be given a higher and more binding status where pan-EU and cross-border issues are concerned, so that the *selection* role of CESR could be made more entrenched. However, as competition regulation has had a history of centralisation in administration before the decentralisation took place, it may be proposed that CESR should be responsible for pan-EU, foreign and cross-border issues, such as the approval of foreign issuers, cross-border entities, as well as supervision and enforcement against such entities. This taking on of *effectuation* by CESR would strengthen the systemic structure of regulatory convergence as the multitude of *selectors* and *effectors* are both reduced, and CESR may take control over some *effectuation* which is not possible under the current framework. Pan-EU entities and entities with cross-border operations and effects should thus approach CESR directly. National regulators should also perhaps be obligated to transfer matters upwards if it involves a pan-EU or cross-border dimension, and CESR could have the pre-emptive power to direct such transfer like the Competition Commission. Purely national matters should however remain primarily at the disposal of national regulators. Purely domestic needs are very different from pan-European needs, as the interests of domestic small businesses and retail investors in each jurisdiction may be different and a closer physical presence on the ground by involved national regulators may be necessary.<sup>100</sup> Such a systemic structure would address by and large the cybernetic problem of multitudes of *selectors* in regulatory convergence, and the hitherto weak control by CESR over *effectuation* in Member States.

It may however be argued that an obligation to make "upward transfers" would violate the nature of shared competence in the Internal Market, and even this is not required under competition regulation. However, in competition regulation, "upward transfers" no longer feature as an issue because the *ex ante* notification system has been abolished. Prior to the abolition, there was also no issue of "upward transfers" as the Commission had central

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<sup>100</sup> Daniel Gros and Karel Lannoo, *The Euro Capital* (Chicester: John Wiley & Sons 2000). Also Guido Ferranini "MIFID and the Lamfalussy Structure" paper presented at the University of Cambridge, 26 April 2005.

administration. National agencies in competition regulation are now only administering the *ex post* supervision over anti-competitive conduct. Where securities regulation is concerned, many *ex ante* procedures are needed, in approving a prospectus and authorising investment intermediaries and markets. It is suggested that in these *ex ante* procedures, perhaps CESR as an EU agency could be responsible for the approval or authorisation of an entity that is likely to have cross-border operations or effects throughout the EU. National regulators should remain responsible for solely domestic outfits and could make “upward transfers” if an entity seeking authorisation or approval is likely to entail cross-border effects. “Upward transfers” would probably strengthen CESR’s role in regulatory convergence, as it reduces the opportunities of regulatory arbitrage being taken advantage of by forum-shopping applicants.

Moreover, this thesis acknowledges that a clear line may be difficult to draw between issues with a pan-EU element and purely domestic issues. A transaction involving a retail investor who has bought securities issued by a domestic entity may on the one hand be “purely domestic”, but if the issuer is also pan-European, then it may be difficult to see where the supervisory jurisdiction is divided between CESR and the national regulator. The resolution of these issues may require further development in time, for example, CESR could have the pre-emptive power of transfer, and like the Competition Commission, could require all national investigative actions to be reported, so that a general oversight of every case may be maintained, especially to ascertain if a pre-emptive power needs to be exercised. Structural features that are based on the cybernetic principles of minimising *selector* problems and bringing coherence to controlling *effectuation* and *feedback* would provide guiding principles to the design of operational processes in CESR’s relationship with national regulators.

The Commission in its Green Paper<sup>101</sup> mooted the idea of having a 26<sup>th</sup> regime for “EU securities regulation” apart from the 25 regimes of national securities regulation in the EU.

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<sup>101</sup> Green Paper on Financial Services Policy 2005-2010, COM(2005)177.

The Green Paper did not however detail how the 26<sup>th</sup> regime should relate to the other 25 and soon-to-be 27 regimes. This thesis suggests that the 26<sup>th</sup> regime and the other national regulations could operate in a two-tier framework,<sup>102</sup> the division of the tiers being based on whether the administration has a pan-EU element or otherwise. Such division, as discussed, may have to be adapted and modified in due course depending on how market practices may challenge the line of division

Second, the competition regulation model indicates that there is a certain amount of verticalisation imposed by the Commission in having a pre-emptive power of transfer and having the power to intervene in national judicial proceedings as *amicus curiae*. Such verticalisation arguably pertains mainly to the norm-setting function for competition regulation, as the Commission is likely to exercise pre-emptive transfer if, for example, it regards an issue as having precedential value and it should therefore make a decision.<sup>103</sup> Its power to intervene in national judicial proceedings is also intended to affect both how the law is made as well as how the law is interpreted. Thus, although decentralisation creates a number of national *effectors* in competition regulation, the Commission has put into place powers to control the development of the law in terms of the norm-setting aspect of the regulatory system.

If CESR as an EU agency is responsible for pan-European and cross-border issues and national regulators are responsible for solely domestic issues, such a division would arguably achieve a more cybernetic system for regulatory convergence than under the current arrangement made for competition regulation. The decentralised competition regulation

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<sup>102</sup> Irina Shirinyan, "The Perspective of US Securities Disclosure and the Process of Globalisation" (2004) 2 DePaul Business and Commercial Law Journal 515. A two tiered system is suggested for international convergence of securities regulation for international players, and national infrastructures for purely domestic businesses. See also Guido Ferranini, "Contract Standards and the Markets in Financial Instruments Directive- An Assessment of the Lamfalussy Regulatory Structure" (2005) 1 European Review of Contract Law 19, where it is argued that a European Securities Regulator should exist to deal with issues that national regulators are unfit to deal with, such as cross-border issues.

<sup>103</sup> There is no available report on how the Commission has exercised this power.

arrangements allow a multitude of *effectors* in administering, supervising and enforcing Articles 81 and 82 of the Treaty of Rome. However, the proposed division of responsibilities between CESR and national regulators could create a centralised *effector* in CESR for pan-European and cross-border entities, while national regulators continue to have *effector* functions only where those are limited to purely domestic issues. CESR as a centralised, EU-level *effector* could have control over the administration, supervision and arguably enforcement of EU securities laws, and in the process further its *norm-selection* role in interpreting how law in action should be carried out. By having responsibility for the approval and authorisation processes, CESR could put into place how various terms ought to be interpreted, such as “sufficiently good repute” required for intermediaries. CESR could arguably be endowed with the power and resources to supervise pan-EU entities, or to appoint co-supervisors in national jurisdictions where the entity may have significant operations. CESR may also levy administrative penalties so that it could administer enforcement itself. The concentration of systemic functions, i.e. the centralisation of *selection* and *effectuation* of EU securities norms relating to pan-EU entities in CESR, would give rise to a cybernetic system for regulatory convergence. However, if we move along the spectrum and consider more delegated *effectuation* to national regulators, vertical powers akin to the ones the Commission has, may be designed to ensure a form of control by CESR over firstly, *selection of norms*, then national *effectuation*. This also has to be flanked by information sharing and contact between CESR and the national regulators in order to maintain coherence between the *selection* of norms by CESR, and the *effectuation* of such norms in Member States, and to provide dynamic *feedback* into possible systemic changes in the future.

In sum, what seems to be important from the lesson in the Competition regulation model in systemic terms, is that *selection* of norms should be controlled, and where delegation of *effectuation* is made to national regulators, some vertical processes may also help in controlling *effectuation* by multiple actors. The Competition regulation model is also

supported by extensive *information-sharing* and *feedback*. Chapter 3 has earlier discussed the current mechanisms that CESR is using, i.e. mediated outcomes for supervisory differences, Review Panels to monitor supervisory differences between Member States, and a database of enforcement decisions to encourage convergence by Member States. These mechanisms are cybernetically weak in the *selection* of norms, although persuasive and regime forces may provide some *effectuation* control. These mechanisms are however strong on *information-sharing* and *feedback*. If these mechanisms could be reframed into institutional devices, with some form of vertical authority, CESR would be able to set the norms for interpretive, supervisory and enforcement convergence, even where it is not directly *effectuating* the securities regulation norms.

### ***European Central Bank Model***

Another model that is briefly discussed here is the European System of Central Banks (“ESCB”) which consists of the European Central Bank (“ECB”), flanked by the network of national central bankers (“NCBs”).<sup>104</sup> The ESCB system is arguably a cybernetic system, achieving a convergence of policy and regulation, as it has an institutional structure of hierarchy and authority and clear division of responsibility between the ECB and NCBs, producing unity in policy-making, action, feedback,<sup>105</sup> and response to feedback. The ECB and NCBs are both represented in a Governing Council that may make decisions on monetary issues and internal procedure.<sup>106</sup>

The ESCB model seems to reinforce the suggestion made in the foregoing discussion, that centralisation of *selection of norms* is an effective way of maintaining administrative

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<sup>104</sup> See Ralph Mehnert-Meland, *Central Bank to the EU* (London: Kluwer Law 1995) at 71ff.

<sup>105</sup> The ECB may arguably obtain feedback when it produces annual reports to the European Parliament and engages in processes of accountability and transparency.

<sup>106</sup> Articles 10, 12 and 14, Protocol in n80.



coherence and unity.<sup>107</sup> Furthermore, the ESCB model centralises *effectuation* in certain areas where the ECB is exclusively competent, for example, in issuing currency<sup>108</sup> and in international representation.<sup>109</sup> The centralisation of pan-EU *effectuation* is also supported in this thesis for CESR. However, the lack of centralisation of an *effector* at EU level need not necessarily be a serious systemic deficit in the cybernetic sense. The delegation of *effectuation* could still be accommodated within a cybernetic model as the Competition regulation model endeavours to achieve. The ESCB model also shows how the relationship between the central *effector* and national counterparts is important in another cybernetic aspect, and that is information gathering and feedback, through regular meetings and contact, and performing reporting functions as a coherent entity. Such contact is essential for the cybernetic aspect of informing the continuity of the *selection* and *effectuating of norms* within the system.

Another issue that has to be considered is representation of national regulators in CESR the agency. In both the Competition regulation and ESCB models, national counterparts are co-opted in policy making and *norm selection*. Therefore, where CESR is concerned, it is proposed that national regulators should continue serving as members of the Board. However, like the separation between the Executive Board of the ECB which is responsible for day-to-day management, from the Governing Council, CESR the agency could be separately run from the network participation of national regulators. This is because the network's objectives are to provide regular contact, information and feedback into the regulatory system, so that the cybernetic aspect of systemic modifications and renewal may take place. The network should refrain from constituting an alternative norm *effector* in CESR's proposed operational functions. However, to what extent should the network affect *norm selection*? The network may be given powers to directly affect *norm selection*, like the Governing

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<sup>107</sup> Article 4, Protocol in n80.

<sup>108</sup> Article 105a, Treaty of Rome, and Article 16, Protocol in n80.

<sup>109</sup> Article 6, Protocol in n80.

Council to the ESCB, but such powers may be designed by reference to majority voting or consensus. The design of the network is important, as in the absence of design, the network would be a network of equal regulators and in the absence of hierarchy and structure, this network may retain regime characteristics that are relatively less stable than in a formal organisation. On the other hand, the network of national regulators could also be merely advisory in nature, like in the Competition regulation model. Under that model, the Advisory Committee formed by national regulators may provide advisory feedback, and such an advisory network could be incentivised to provide information and feedback because the law makes it mandatory for the agency to consult the advisory network. However, the Competition regulation model makes it non-compulsory for the Commission to adopt the advice given by the advisory network. In view of the nature of shared competence in regulating this area of the Internal Market, it is suggested that perhaps a more prominent legal status may be given to the contact between CESR and its national counterparts and the nature of its input.

Both the Competition Regulation and ESCB models seem to suggest that a convergent regulatory system requires a certain amount of centralisation in norm-setting, although in terms of *effectuation*, delegation to national counterparts is seen to be appropriate and necessary. The analysis from cybernetics and the two models above suggest that the foremost important step in ensuring cybernetic regulatory convergence is that CESR's control over norm-setting has to be strengthened, and in particular, CESR's guidelines and recommendations have to be given a more prominent status, and perhaps should attract judicial support.<sup>110</sup> Second, the Competition regulation and ESCB models both provide systems of control over the delegated *effectuation* of norms, the Competition Commission through its pre-emptive power of transfer and the ESCB through the Governing Council's decisions by majority voting. This amount of verticalisation may be used to control diffusion

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<sup>110</sup> Discussed in chapter 2, Part 2.4.5.

in norm-setting. This type of governance has already been described as “decentralised integration”.<sup>111</sup> Thus, there is also a need to consider how exactly CESR may cybernetically exert some form of verticalisation over delegated *effectuation* in order to attain a decentralised form of integration that would still achieve regulatory convergence.

The decentralised integration model seems to show the way to a cybernetic regulatory system for EU securities regulation to achieve regulatory convergence. However, besides strengthening *norm-selection* and control over *effectuation* as discussed above, CESR, as an agency also needs to have the same *regulatory* competence as the national counterparts, and more. The theoretical journey undertaken using the cybernetic model of analysis may suggest that the commentators who have argued at length for an EU securities agency may be right after all.<sup>112</sup>

What about the role of the national and European courts in a cybernetic regulatory system? In cybernetic terms, the role of the court would possibly provide an alternative *selection* of norms in the interpretation of securities laws, and that could influence future *effectuation* of norms by national regulators. The court’s role may be regarded as a form of fragmentation in the *selection* of norms. However, total centralisation of systemic functions such as norm *selection* and *effectuation* concentrates power in the hands of the EU agency, and the role of the Court, as in any national court, is to check the balance of executive power. Particularly in this time where concerns and fears have been raised as to the democratic deficit of executive agencies, the role of the court would be important in providing a countervailing influence in the political landscape. For example, the European Court has recently overturned the

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<sup>111</sup> Edoardo Chiti, “Decentralisation and Integration in Community Administration: A New Perspective on European Agencies” (2004) 10 ELJ 402.

<sup>112</sup> M Andenas, “Who is Going to Supervise Europe’s Financial Markets?” in Andenas and Avgerinos (eds), *Financial Markets* (2003) op cit at n78 at xv. Roberta S Karmel, “The Case for a European Securities Commission” [1999] Columbia Journal of Transnational Law 9; Eric J Pan, “Harmonisation of US-EU Securities Regulation: The Case for a Single European Securities Regulator” (2003) 34 Law and Policy in International Business 499; and Avgerinos, “The Need for” (2003), op cit at n39.

Commission's decision to allow Sony and BMG to merge,<sup>113</sup> and although the effect of this is that the Court is an alternative *selector* of norms, it only does so in a limited sense. The Court's ruling may be confined to the case, or render an agency decision wrong as not being in accordance with law, but the Court cannot fashion norms positively in the way that a *selector* can. The role of the Court is thus more of a form of feedback into the regulatory system, requiring amendment of the norms where necessary. However, national courts' rulings may bring about divergences in regulatory norms which can be entrenched in a national system, that do not feed back at a pan-European level. However, the predominant use of administrative penalties may, on the other hand, encourage much enforcement to take place outside the court. These enforcement practices may then be led by CESR, as an agency, to forge convergence in enforcement. To what extent national judicial fragmentation may affect a cybernetic system for regulatory convergence, is difficult to tell for now. However, from both a theoretical perspective in systems and organisations analysis, and from the examples of competition regulation and the ESCB, the agencification of CESR, endowed with a regulatory role with respect to pan-European and cross-border matters, is likely to achieve most of the necessary features for a cybernetic system for regulatory convergence.

### 3.2 Agency Design

In this part, the issue of the "design" of CESR is discussed. Should CESR be part of the Commission like the Competition Commission, or an independent EU agency?<sup>114</sup>

The Competition Commission is *nested* within the Commission, but it has developed a distinctive identity and publishes its own annexed annual report to the Commission's annual

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<sup>113</sup> *Independent Music Publishers and Labels Association (Impala, International Association) v. Commission of the European Communities, (Bertelsmann Ag and Others, intervening)*, Case T-464/04, [2006] 5 CMLR 19.

<sup>114</sup> Some general discussion on the relationships of agencies to each other, particular in the nested/independent framework, could be found in Vinod K Aggarwal (ed), *Institutional Designs for A Complex World* (Ithaca: Cornell University Press 1998).

report. It also produces its own legislative output in respect of hard and soft law, based on the competencies granted under Articles 85 and 86 of the E.C. Treaty. The following table shows a sample of the legislative output of the Competition Commission between 2001-5:

Output/year	2001	2002	2003	2004	2005
Hard law (regulations or directives)	1	5	3	4	3
Soft law (notices or communications or guidelines)	2	6	2	2	6
Review studies	21	23	19	No information	5

Although the Competition Commission is actually only one of the Directorates of the entire European Commission, it has effectively been institutionalised as a regulatory agency. The Competition Commission is an example where institutionalisation of EU competition law has been successful under an organised outfit which dedicated itself to competition regulation at the EU. Although the organisation is not an independent agency but nested within the Commission, the institutionalisation of EU competition law has not been affected.

Even if CESR were to be nested within the European Commission, it could develop an autonomous identity. The Competition Commission is also respected as an entity at international negotiations and discussions. CESR may conceivably be a separate member of IOSCO alongside other national regulators.

Nesting within the Commission may be beneficial in terms of financial support for CESR and nestedness may also improve CESR's linkages with other financial regulatory systems and the Internal Market Directorate.<sup>115</sup> Independent agencies may be harder to justify in the EU, as several creations have needed Treaty amendments, such as the European Central Bank or the EU Court of Auditors. However, it has been argued that any EU securities agency is unlikely to require a Treaty amendment,<sup>116</sup> and agencies such as the European Agency for Evaluation of Medicinal Products (EMA) which facilitates a single-market authorisation for human and veterinary medicines, and the non-administrative European Environment Agency (EEA) which provides information for policy-making by other EU institutions, were set up with relative ease.

The Commission's White Paper on Governance casts some doubt on the future desirability of independent agencies.<sup>117</sup> However, Professor Majone who has written much in support of independent functional agencies argues that independence achieves certain benefits for the agency in terms of credibility and legitimacy. Independence allows professional dedication to the tasks of the agency and this may create more confidence and credibility for the agency.<sup>118</sup> The European Commission has been often criticised<sup>119</sup> to be a politicised type of bureaucracy and thus, agency functions may be tainted by political hints. Although a classic fear against agencies is that agency drift<sup>120</sup> may occur, in the EU context, political drift may be a worse possibility. This means that the agency adopts a political agenda of its own and pursues it,

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<sup>115</sup> Flinders, "Distributed Public Governance" (2004), op cit at n77

<sup>116</sup> Avgerinos, "The Need for" (2002), op cit at n39.

<sup>117</sup> See discussion by Daniel Wincott, "The Governance White Paper, the Commission and the Search for Legitimacy" in A Arnall and D Wincott (eds), *Accountability and Legitimacy in the EU* (Oxford: Oxford University Press 2002) at 379.

<sup>118</sup> G Majone, "The New European Agencies: Regulation by Information" (1997) 4 JEPP 262 ; Everson, "Independent Agencies?" (1995), op cit at n76 and Majone, *Regulating Europe* (1996), op cit at n71 at chapter 13.

<sup>119</sup> Thomas Christiansen, "Tensions of European Governance: Politicised Bureaucracy and Multiple Accountability in the European Commission" (1997) 4 JEPP 73.

<sup>120</sup> The classic principal-agent problem in economics is that the agent that has received delegation to manage a certain issue area then manages for its own interest such as self-perpetuation. See for example Michael C Jensen and William H Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs" (1976) *Journal of Financial Economics* 3, discussing agency drift in the corporate context.

“drifting” away from its original mandate. However, agencies embody certain goals and tasks, and compared to political agreements, it has been argued that they are likely more stable and persistent in policy development and may provide a better sense of continuity and certainty in achieving regulatory convergence.<sup>121</sup> If CESR is to mete out sanctions and enforcement, independence would be beneficial to its enforcement role, and it would be seen to be less likely susceptible to political interferences.<sup>122</sup>

The ESCB model is a model that has entrenched independence in its Statute,<sup>123</sup> preventing national central bankers and the ECB from being susceptible to political influences. This model is again unique because of its pre-eminent economic function of maintaining price stability across the eurozone. However, where a regulatory agency is concerned, independence from the Commission or otherwise need not affect its enforcement credibility, as the Competition Commission has shown. Although *nestedness* may improve policy linkages especially with different Directorates of the Commission, the Commission’s participation may also be provided for even if an agency is not nested. Hence, it may not matter too much whether CESR is nested or otherwise within the Commission.

This thesis proposes that it may be more ideal for CESR not to be nested within the Commission, as it is likely to be an agency flanked by a network of national regulators, and the structure of this working relationship as discussed earlier, gives rise to design complications in the areas of influencing norm *selection* and effective information feedback. This structure may be complicated if CESR is nested within the Commission and has to incorporate hierarchy and order structures within the Commission. Hence, CESR as an independent agency may be preferred.

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<sup>121</sup> Anand Menon and Stephen Weatherill, “Legitimacy, Accountability and Delegation in the EU” in Arnall and Wincott (eds), *Accountability and Legitimacy* (2002), op cit at n117 at 113.

<sup>122</sup> Ferranini, “MIFID”, op cit at n100.

<sup>123</sup> Articles 7 and 14, Protocol in n80.

### 3.3 Democratic Deficit and Legitimacy

The concern of democratic deficit is not unique to CESR but applies to many EU institutions where decision-making is seen as increasingly alienated from the citizenry and there is a sense of a lack of accountability.<sup>124</sup>

If CESR is nested within the Commission, although the issue of democratic deficit would have to be addressed by the Commission as a whole, there would still be a need for CESR to ensure that its practices are accountable. The discussion that follows would apply whether CESR is nested within the Commission or is independent.

There are two perspectives on this issue. One, is the “postmodern”<sup>125</sup> view that since the EU and its institutions are a new form of governance altogether, traditional state-based understandings of democratic deficit should not automatically be used to criticise the EU, which cannot have totally state-like structures. A study carried out that compares EU democracy to that in the US and Switzerland concludes that the EU is just as “democratic” on an assessment of 5 indicators, i.e. transparency, accountability, consensus, redistributive considerations and legitimacy.<sup>126</sup> Moravcsik also compares the features of EU governance to contemporary democratic governance, and concludes that those features such as agencification, political checks and balances, and capacity to exercise power are similar to

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<sup>124</sup> Pedro Gustavo Teixeira, “Public Governance and Co-operative Law of Transnational Markets: The Case of Financial Regulation” in Karl-Heinz Ladeur (ed), *Public Governance in the Age of Globalisation* (London: Ashgate 2004) at 305ff.

<sup>125</sup> For example, Ian Ward, “Identity and Difference: The EU and Postmodernism” in Jo Shaw and G More (eds), *New Legal Dynamics in the European Union* (Oxford: Hart 1995) where it is argued that the identity of Europe is in its very diversity and the inability to fully integrate.

<sup>126</sup> Thomas D. Zweifel, “Who is without Sin Cast the First Stone” (2002) 9 JEPP 812.



state governance, if not more restrained. Thus, the EU's democratic deficit seems to be more of a perception than fact.<sup>127</sup>

That said, however, there is a need to consider if measures may be deployed by EU institutions to meet the charges of democratic deficit.

There is a copious amount of literature on the unique nature of EU governance, in relation to which some ideas have been discussed in Part 2.4.5 of chapter 2. It is arguable that the complexity of EU governance itself provides checks and balances. Cohen and Sabel call the EU a "deliberative polyarchy" which has a central framework in some respects but engages in a deliberative type of learning/decision-making process that is highly negotiative and intergovernmental in nature.<sup>128</sup> Therefore, individual institutions such as the Commission and independent agencies are frequently operating in a wider network with other actors, and such actors provide the checks and balances to the decision-making process in these agencies. For example, the Commission has an Inter-Institutional Monitoring Group, consisting of the Parliament, Council and Commission, that reports on regulatory convergence in securities regulation, and this Group consists of observers from the ECB as well. Thus, it may be argued that EU institutions are unlikely to be completely opaque. Constitutional commentators are increasingly focusing on the procedural frameworks governing linkages among different governance actors,<sup>129</sup> and argue that these procedural linkages provide for participation and dialogue among governance actors, and such structures address the concerns for credibility and legitimacy.

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<sup>127</sup> "In Defence of the "Democratic Deficit": Reassessing Legitimacy in the EU" in Joseph Weiler, Iain Begg and John Peterson (eds), *Integration* (London: Blackwell 2003) at 77.

<sup>128</sup> "Sovereignty and Solidarity: EU and the US" in Ladeur (ed), *Public Governance* (2004) op cit at n124, at 157.

<sup>129</sup> Pedro Gustavo Teixeira, "Public Governance" in Ladeur (ed), *Public Governance*, ibid, and Julia Black, "Proceduralising Regulation" Parts 1 and 2, in (2000) 20 OJLS 597 and (2001) 21 OJLS 33 respectively, where it is argued that although proceduralisation is an important modern phenomenon in shaping regulation, particularly in decentred analyses, what type of proceduralisation, ie thick, involving consensus and deliberations, or thin, involving a more liberal form of democracy like majoritarian voting, is dependent on substantive values of regulation such as democracy itself.

However, to the citizenry, inter-institutional processes may remain opaque. There is arguably a need for institutionalising procedures that allow for more transparency in the governance process and participation by citizenry in the decision-making process. In terms of transparency of the governance process, there are two aspects, i.e. observability within the network, and political accountability.<sup>130</sup>

Ladeur thinks that the “observability” of EU agencies is key to its democratic quotient. Observability not only refers to different parts of the network being able to observe each other and engage in a continual process of dialogue, it also refers to open-ness and participation by the public.<sup>131</sup> Allowing observability within the network is already at work, and an example is the accountability process of the European Central Bank which allows for inter-institutional observation and reporting to the European Parliament.<sup>132</sup> Political transparency and accountability are also often achieved by allowing political observation such as by the Parliament, and budget discipline.<sup>133</sup> In terms of public accountability and participation, Cohen and Sabel suggest that EU institutions should respect the right of speech regarding EU governance, and allow for public participation.<sup>134</sup> They opine that EU institutions should inform the public, and engage the public in meaningful debate, and allow

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<sup>130</sup> Accountability may be achieved vis a vis different groups of interested persons, and different arrangements for different types of accountability may be put into place. For example, there could be ministerial accountability, political accountability, judicial accountability, stakeholder accountability, consumer accountability and audit accountability. See Eva Huepkes, Marc Quintyn and Michael W Taylor, “The Accountability of Financial Sector Supervisors: Principles and Practice”, (IMF Working Paper January 2005, on file with author).

<sup>131</sup> Karl-Heinz Ladeur, “Globalisation and Conversion of Democracy to Polycentric Networks: Can Democracy survive the End of the Nation State?” in Ladeur (ed), *Public Governance* (2004), op cit at n124 at 89.

<sup>132</sup> Paul Magnette, “Towards “Accountable Independence?” Parliamentary Controls of the ECB and the Rise of New Democratic Models” (2000) 6 ELJ 326. The ECB’s practices have however been criticised, as although it makes reports and appears before the European Parliament 4 times a year, the President has always been vague and the quality of disclosure has not been felt to be satisfactory. See Fabian Amtenbrink, “On the Legitimacy and Democratic Accountability of the ECB: Legal Arrangements and Practical Experiences” in Arnall and Wincott (eds), *Accountability and Legitimacy* (2002), op cit at n117 at 147.

<sup>133</sup> An analogous discussion regarding the UK Financial Services Authority can be found in Alan Page, “Regulating the Regulator: A Lawyer’s Perspective” in E Ferran and C Goodhart (eds), *Regulating Financial Services and Markets in the 21<sup>st</sup> Century* (Oxford: Hart 2001) at 127.

<sup>134</sup> See Alan Dashwood, “Issues of Decision-Making in the EU after Nice” in Arnall and Wincott (eds), *Accountability and Legitimacy* (2002), op cit at n117 at 13.

public feedback.<sup>135</sup> Public accountability may also be achieved by periodic disclosure and reporting.<sup>136</sup> In this respect, CESR's current information gathering structures may already be meeting these requirements, as there are systematic engagements with market participants for discussion and feedback,<sup>137</sup> and CESR has also had "public open days" such as the "MIFID consumer day" of 22 March 2005 to engage consumer representatives in understanding MIFID.

However, Arnall<sup>138</sup> points out that legitimacy is also a "social issue", in that the citizenry must *perceive* that the requirements of democratic legitimacy have been met. CESR has shown a track record of being responsive to public suggestions, and have delayed reporting and launched further consultations based on public responses.<sup>139</sup> CESR also publishes all written responses to their public consultations,<sup>140</sup> and it is easy to compare industry responses with the ultimate CESR recommendations. However, public participation has been criticised as not amounting to "democracy".<sup>141</sup> Critics view public participation measures as "diffuse democracy", which is not effective, as the ultimate sanction of removal from power is unavailable.<sup>142</sup>

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<sup>135</sup> Renaud Dehousse, "European Governance in Search of Legitimacy: The Need for A Process-based Approach" in O de Schütter, N Lebessis and J Paterson (eds), *Governance in the EU* (Office for the Official Publications of the EC 2001). See also "Sovereignty and Solidarity" in Ladeur (ed), *Public Governance* (2004), op cit at n124. See also Flinders, "Distributed Public Governance" (2004), op cit at n77; and Olsen, "Reforming" in Weiler, Begg and Peterson (eds), *Integration* (2004), op cit at n44 discussing the process-based approach as a form of constitutionalism in the EU.

<sup>136</sup> Dehousse et al, "Europe After 1992" (1992), op cit at n66.

<sup>137</sup> Part 2.3 of chapter 4.

<sup>138</sup> "Introduction to the EU's Accountability and Legitimacy Deficit" in Arnall and Wincott (eds), *Accountability and Legitimacy* (2002), op cit at n117 at 1.

<sup>139</sup> For example, CESR launched a consultation on the notification procedure on UCITS, and after receiving responses by 5 May 2006, decided to launch a further consultation in an open day on 11 May 2006 to further to consult on issues arisen from the first round of consultations.

<sup>140</sup> All consultation on the consolidation of market transparency data is available at [www.cesr-eu.org](http://www.cesr-eu.org).

<sup>141</sup> See Wendy Netter Epstein who proposes that citizenry consultation resulting in reforms is a form of bottom-up reform, an expression of democracy. "Bottoms Up" (2004) 56 *Administrative Law Review* 739; see Peter Dryberg, "Accountability and Legitimacy: What is the Contribution of Transparency?" in Arnall and Wincott (eds), *Accountability and Legitimacy* (2004), op cit at n117.

<sup>142</sup> Paul Magnette, Christian Lequesne, Nicolas Jabko and Olivier Costa, "Diffuse Democracy in the EU" (2003) 10 *JEPP* 834.

It may also be argued that it is difficult for CESR to improve its democratic quotient as the concept of regulatory convergence is itself undemocratic. Regulatory convergence arguably seeks to minimise diversity, and thus could be viewed as oppressive and discouraging of pluralism and diversity in the EU.<sup>143</sup> However, the proposed two-tier framework of securities regulation in the EU is a form of decentralised integration and arguably allows for the necessary national diversities to exist. Furthermore, in terms of regulatory convergence at the EU level, there could be economic benefits that may provide “output legitimacy”.<sup>144</sup> So, even if there may be limits to a direct exercise of citizenry power in democratic voting, the democratic deficit may be ameliorated by “output legitimacy”.

Output legitimacy occurs where the agency’s administration produces economically effective and efficient results for the EU. Output legitimacy can be measured, for example, in terms of, but not limited to, market turnover in securities. An increased turnover in market trading may mean increased investment activity and signal growth in the capital markets in the EU. Such measurements are readily perceived by the citizenry, and could be immediately useful for improving an agency’s legitimacy.<sup>145</sup> Scharpf is of the view that input legitimacy, which is described above as channels of public participation and disclosure to the public, does not make any real difference in social perception of an agency’s legitimacy.<sup>146</sup> Two other commentators also argue that output legitimacy is important as it reflects actual achievements and is practically relevant to modern life.<sup>147</sup>

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<sup>143</sup> Carol Harlow argues that such diversity should be respected and maintained in EU regulation and operations, see “Voices of Difference in a Plural Community” (2002) 50 *American Journal of International and Comparative Law* 339.

<sup>144</sup> See *infra*.

<sup>145</sup> Fritz Scharpf, “Economic Integration, Democracy and the Welfare State” (1997) 4 *JEPP* 18, and *Governing Europe* (Oxford: OUP 1999) where it is argued that the problem-solving capability of Member States is being undermined because of market integration and this results in citizenry perception that democratically elected officials can no longer solve the country’s problems. This is the root cause of perceived democratic deficit. If the EU can take over problem-solving and provide useful positive integration for the single market, this may help improve its perceived democratic deficit.

<sup>146</sup> *ibid*.

<sup>147</sup> Menon and Weatherill, “Legitimacy, Accountability”, *op cit* at n121.

If CESR has regulatory competence at the EU level, it could administer a one-stop application procedure for pan-EU and foreign participants. A “one-stop” institutional framework allows regulatory services to be provided at the European level, and is able to overcome the limits of national regulation. Issuers may become more attracted to the EU markets, and more capital raising may entail market growth and increased investment activity across the EU. CESR also reported in June 2006<sup>148</sup> that an outfit that provides a form of centralised data storage of issuers in the EU and maintains links with home state information providers, may be necessary to achieve one-stop shop information provision for investors, enhancing investor protection in the EU. There is thus a need for a pan-EU structure that could provide pan-EU services for the Internal Market. Professor Andenas also argues that a pan-EU institutional solution is necessary for the regulation of EU financial markets, as the complexity and integrated nature of financial services, products and markets require consolidated and not disparate regulatory solutions.<sup>149</sup> The benefits that may be derived from CESR’s pan-EU administration may improve its legitimacy and define its role clearly for citizenry.

The formalisation of CESR’s role also improves “trust”, which is an important element of sustaining organisational identity and continuity.<sup>150</sup> Often, the achievement of actual beneficial effects is the basis for citizenry acceptance of a form of EU governance.<sup>151</sup> One critique against output legitimacy is that it is inordinately difficult to measure how effective an agency is, because it is uncertain what economic value could be put on public goods such

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<sup>148</sup> CESR’s Final Technical Advice on Possible Implementing Measures Concerning the Transparency Directive: Storage of Regulated Information and Filing of Regulated Information, CESR 06/292, June 2006.

<sup>149</sup> “Who is Going?”, *op cit* at n112.

<sup>150</sup> Paul Willman, David Coen, David Currie and Martin Siner, “The Evolution of Regulatory Relationships, Regulatory Institutions and Firm Behaviour in Privatised Industries” (2003) 12 *Industrial and Corporate Change* 69.

<sup>151</sup> Ulrich Haltern, “Pathos and Patina: The Failure and Promise of Constitutionalism in the European Imagination” (2003) 9 *ELJ* 14.

as “investor confidence”.<sup>152</sup> However, it is arguable that other measures such as an increase in investment activity, and market trading turnover, or in the total number of new listings, can be made, and these may give good indications of the growth of securities markets.

The following is an example to show how CESR as an agency may improve and enhance the integrality of EU securities markets and make the EU markets an attractive destination for more foreign capital. This may be a form of output that could improve democratic endorsement of the agency.

### *3.4 Output Legitimacy?- A European Style Notification*

One of the advantages of direct pan-EU regulation by CESR is that greater administrative convenience may be offered to pan-European issuers.

Referring to Howell E Jackson and Eric J Pan's quantitative survey<sup>153</sup> carried out to ascertain the nature and type of securities offerings made in Europe, a certain pattern in issuer demand may be discerned, for the type of regulation that issuers are attracted to. Jackson and Pan's study found that most securities offerings that are intended to be cross-border offerings are styled "international" i.e. that they could be prepared for an offer in the EU as well as in the US, particularly in New York. Cross-border offerings that are confined to the EU are extremely rare. Thus, issuers wish to be able to prepare one set of documents that would enable them to access all the intended markets. As such, an issuer's perspective is not limited by the jurisdictional boundaries of different issuing locations, and they think "international" when referring to the entire offering. To attract pan-European offerings across Europe, the

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<sup>152</sup> Charles A.E. Goodhart, “Regulating the Regulator: An Economist’s Perspective: Accountability and Control” in Ferran and Goodhart (eds), *Regulating Financial Services* (2001), op cit at n133.

<sup>153</sup> Howell E Jackson and Eric J Pan “Regulatory Competition in International Securities Markets-Evidence from Europe 1999 Part I” (1999) 56 *Business Lawyer* 653.

regulatory framework should reflect the market demand for "wide and single access".<sup>154</sup> As the US markets are suffering from the unattractive appeal of Sarbanes-Oxley compliance requirements, and more liquidity may be found in Europe, European markets are becoming increasingly popular for issuers, including private equity flotations.<sup>155</sup> The passport regime intends to facilitate single access to multiple jurisdictions, but it does not consider "multiple jurisdictions" as a "single, wide portal". Issuers intending to make multi-state offerings have to notify their home regulator who then notifies the relevant host regulators.

If CESR is a European agency for EU securities regulation, it could receive applications directly from pan-EU issuers, and put in place a system of "European notification" for cross-border offerings. This will allow issuers to consider European markets as a single wide market, and will not require them to select individual jurisdictions to which notification of cross-border issues must be sent. The "European notification" can be an automatic notification to all national regulators, and the offer can be potentially open to all European investors. The provisions of shelf registration can further assist this scheme.

### ***Shelf - Registration***

In order to facilitate the "European notification", it is suggested that the provisions on shelf registration in the Prospectus Directive be utilised. The Directive provides for shelf registration<sup>156</sup> for issuers so that issuers may have the option of registering a prospectus, but staying the offer for a while, and decide when to access a market within 12 months of the shelf registration. This is particularly useful for a "European notification", as a notification to the entire European market may be treated as shelf-registered in those jurisdictions where the offer is not actually made. Even if issuers do not access a particular national market during

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<sup>154</sup> It was also suggested in the context of global securities offerings that a global form prospectus should be developed to facilitate totally mobile and wide access, Uri Geiger, "The Case for the Harmonisation of Securities Disclosure Rules in the Global Market" [1997] Columbia Business Law Review 241.

<sup>155</sup> Two hedge funds, Marshall Wace and KKR floated in Amsterdam in the first quarter of 2007.

<sup>156</sup> Article 12, Prospectus Directive.

the primary offer, it remains open to the issuer, if circumstances change in that market in the next 12 months, and the issuer wishes to issue new shares, to access that market easily.<sup>157</sup> It is however noted that the shelf registration is valid in the US for two years while the Directive provides for a year's validity, which may be too short and uncompetitive.

A "European notification" can work hand in hand with a shelf registration regime. A European notification can result in the application of a presumption of shelf-registration in all Member States. The issuer may then decide if distribution and advertising would be carried out in that Member State. One possible problem that this process may encounter is that if the advertising or publication of the prospectus is done on the issuer's website and that website may be accessible by anyone in the world, then it could be interpreted as an offer to all Member States. Thus, clear signposting on websites may be necessary to avoid misleading investors.

It may however be argued that individual notifications are necessary as the issuer is trying to make contact with the local investor base. However, the counter-argument to that is that, in Europe, the majority of investors are institutional<sup>158</sup> and may themselves be pan-European establishments. It may also be timely to coordinate the policy efforts of internal market completion with investor education, and a "European notification" allows investors to warm up to the idea that the investment base is the whole European market and not divided along national lines. Such pan-European administration may overcome divergences in national regulation in other areas.<sup>159</sup>

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<sup>157</sup> One critique against shelf registration is that the potential benefits that may be obtained by underwriter due diligence before every public offering may be missed. See Merritt B Fox, "Shelf Registration: Integrated Disclosure and Underwriter Due Diligence: An Economic Analysis" (1984) 70 Virginia Law Review 1005.

<sup>158</sup> Chris Mallin, Andy Mullineux and Clas Wihlborg, "The Financial Sector and Corporate Governance: The UK Case" (2005) 13 Corporate Governance 532 document that in the UK, 80% of corporate shareholders are institutional investors.

<sup>159</sup> Manning Gilbert Warren III, "The European Union's Investment Services Directive" (1994) 15 University of Pennsylvania Journal of International Business Law 181 at 185 where a historical survey of the different regimes of national securities regulation in Europe was provided. "[I]n the 1980s, seven of the twelve E.U.



The advantages of the European notification are that issuers would likely appreciate this flexibility in allowing them to decide whether or not to raise capital in any Member State. Such decisions could be taken quickly if they have in principle obtained a passport for the whole EU. They could avoid the inconvenience of a fresh notification having to be made for every jurisdiction "left out" of the original notification.<sup>160</sup> Furthermore, where emerging markets such as the Baltic markets or Polish markets are concerned, rapid changes in conditions may affect an issuer's decision, and the ready availability of an offering opportunity for issuers may be a real attraction for issuers. If issuers have this perspective of being able to access the whole "European market", the reality of the integration of markets may also be hastened. From an investor's point of view, a greater ability of markets to attract issuers also means greater choices in investment, whether by direct participation or indirect participation via collective funds.

The European notification is a type of administration that can take place only if CESR is an EU agency that has the power of *selection* and *effectuation* of norms. This type of administration may result in a wide and single access to European markets, making it attractive for foreign capital. Now that American markets are experiencing greater capital outflows to Europe,<sup>161</sup> particularly because of the onerous corporate reporting and governance requirements in the Sarbanes-Oxley Act, the European notification may become very attractive to foreign issuers. Such wide and single access, supported by a centralised regulator, is not only user-friendly to issuers but to investors, and may result in economic growth output that could cement the legitimacy of the EU administration. If the

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countries did not require prospectus disclosure to investors in public offerings." Furthermore, no Member States "had a securities regulatory agency to enforce the laws that did exist." As late as 1990, "nine of the twelve Member States failed to impose any criminal penalties for insider trading of securities", at 185-186.

<sup>160</sup> M Becht has criticised the EU in general for generating too much paperwork, see "European Disclosure for the New Millennium" in K Hopt and E Wymeersch (eds), *Capital Markets and Company Law* (Oxford: Oxford University Press 2003) at 87ff.

<sup>161</sup> Peter Thal Larsen and Gillian Tett, "European Capital Markets Outpace the US" *Financial Times* (12 December 2006).

agencification of CESR bringing about regulatory convergence actually helps in integrating European markets and attracting capital, then CESR's legitimacy would be based on fulfilling the goal of the Financial Services Action Plan, which is pursuant to the mandate of creating a Single Market for capital.

#### 4. Conclusion

In conclusion, this chapter has argued that the institutionalisation of regulatory convergence may be necessary to overcome the current cybernetic deficits. It has also argued that such institutionalisation may best be achieved by organising a dedicated agency to develop and administer securities regulation that has pan-EU and cross-border aspects.

This chapter suggests that CESR should become the agency for EU securities regulation, and further explores how CESR and national regulators should work together. The models of Competition regulation and the European System of Central Banks are studied, in order to derive the cybernetically important features that CESR could be endowed with, to fashion a cybernetic system to achieve regulatory convergence. It is argued that CESR and national regulators could be placed in a relationship of decentralised integration, where CESR is a regulatory agency that has similar regulatory competencies as national regulators, but has superior *norm selection* functions and a certain extent of control over national *effectuation* of the norms. CESR's domain is however primarily pan-EU in nature, with national regulators delegated with *effectuation* in purely domestic issues.

This chapter also discusses the agency design implications if CESR should become an EU agency, i.e. whether it should be *nested* within the Commission. The chapter concludes with a discussion on the issue of CESR's democratic deficit, which is an issue that affects much of EU governance as well. It is suggested that CESR's pan-EU administration may bring about

practical benefits in capital markets growth that could benefit the EU as a whole and result in a form of output legitimacy, that may go some way towards fulfilling the objective of a borderless internal capital market in the Financial Services Action Plan.

## **Chapter 7**

### **Conclusion**

#### **1. The Policy of Regulatory Convergence in EU Securities Regulation**

EU securities regulation has embarked on the unprecedented movement towards regulatory convergence, which is seen as necessary to facilitate an internal capital market. The policy for EU securities regulation convergence is very much based on a hypothesis that legal integration could entail market integration, and market integration is seen as highly beneficial to overall economic benefit to Member States in general.<sup>1</sup> This hypothesis may be on the right track, as it could be argued that international voluntary convergence is undertaken mainly to allow greater capital mobility, and is thus driven by market demands.<sup>2</sup> The growth of investment products and markets may benefit national economies greatly, as for example, the UK relies heavily on the financial sector to contribute to its economy.<sup>3</sup>

Regulatory convergence in EU securities regulation seems to align both commercial drivers and EU level policy for the completion of the Internal Market. Chapter 1 of this thesis details the expansive coverage of substantive laws in this round of securities regulation reforms. The nature of the substantive laws and amount of detail in the primary Directives and Commission legislation leaves little doubt that the EU level agenda is to secure a kind of regulatory convergence that approximates uniformity.

#### **2. The Cybernetic Model as a Framework to Evaluate Regulatory Convergence**

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<sup>1</sup> Paolo Cecchini, 1992: *The Benefits of a Single Market* (Aldershot: Wildwood House 1988).

<sup>2</sup> See para 2, chapter 5.

<sup>3</sup> Research from a recent BBC programme, What Makes Our Economy shows that the 14 per cent of UK economic activity is based on the financial sector.

As regulatory convergence is not specifically defined and yet appears in many of CESR's policy statements,<sup>4</sup> this thesis suggests that the regulatory convergence desired by EU level policy-makers seems to approximate near uniformity. This suggestion may be supported by the extensive regulatory output on securities regulation at the EU level, and the work of CESR in securing convergence in the law in action i.e. the interpretation, supervision and enforcement aspects of securities regulation.<sup>5</sup>

Thus, chapter 2 suggests that regulatory convergence should capture all aspects of regulation, from substantive textual law, to law in action. Four aspects are identified, namely convergence in sources of law, in interpretation and administration of laws, in supervision, and in enforcement of the laws.

It is also thought that in order to evaluate the current framework for regulatory convergence, the benchmark of a cybernetic model is appropriate. A systemic framework such as the cybernetic model is necessary in order to provide meaningful evaluation of the features of the current framework. The cybernetic model of analysis, a general theory that can be applied to systems of all kinds, is argued to be appropriate as the theory is capable of regarding regulatory convergence in EU securities regulation as a system autonomous of any other system. In other words, the cybernetic model is selected as it supports autopoiesis in law, and this may be apt in considering if EU securities regulation could forge regulatory convergence as an independent legal area. The cybernetic model requires evaluation in the *selection of norms, transduction and effectuation of norms, information and feedback processes* within the system and *securing compliance* with norms. Chapters 2 and 3 carry out a systematic evaluation in the four aspects identified above, to each of the four regulatory aspects of

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<sup>4</sup> For example, CESR Himalaya Report (25 Oct 2004), Annual Report 2006, all available at [www.cesr-eu.org](http://www.cesr-eu.org).

<sup>5</sup> see generally, chapter 3.

sources of laws, administration and interpretation of laws, supervision of compliance with laws, and the enforcement of laws.

The evaluation in this thesis of the current framework is that, in all four aspects of regulation, there are various cybernetic insufficiencies to ensure a systemic approach to regulatory convergence. In terms of the substantive textual law, there is a multitude of *selectors* of norms as Directives give rise to multiversalist laws in Member States. However, it is noted that Commission Regulations have secured some gap-closing in Prospectus regulation and the regulation of stock market price transparency. The general picture though, is that the patchwork of primary Directives and some Commission Regulations are unlikely to secure convergent textual law. An example was provided in chapter 2 of divergent implementation of the Market Abuse Directive in the UK and Germany.

In terms of law in action, CESR's soft law, mediation mechanism and enforcement databases are the primary features in attempting to secure convergence in national regulators' interpretation, supervision, and enforcement of the substantive laws. However, the main issue in all 3 is that CESR's output does not have legal status and hence, CESR arguably cannot set the *norms* for a cybernetic system of regulatory convergence in law in action. In the absence of *norm-setting*, CESR's mechanisms are largely procedural in nature, and may only foster *effectuation* convergence among national regulators by persuasive forces within the network. The verdict is open on whether procedural infrastructure alone may bring about eventual convergence,<sup>6</sup> this issue itself being debated at the general level of the wider EU governance.<sup>7</sup>

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<sup>6</sup> Optimists such as C Joerges believe in the deliberative nature of EU governance ultimately achieving a form of supranationalism, see "Deliberative Supranationalism- Two Defences" (2002) 8 ELJ 133.

<sup>7</sup>Jo Shaw, "Process, Responsibility and Inclusion in EU Constitutionalism" (2003) 9 ELJ 45; Johan P Olsen, "Reforming European Institutions of Governance" in J Weiler, I Begg and J Peterson (eds), *Integration in an Expanding European Union-Reassessing the Fundamentals* (London: Blackwell Publishing, 2004).

Chapter 4 then takes the discussion to a higher level and seeks to ascertain if there is a governance system for regulatory convergence at the EU level. A cybernetic model is applied to evaluate the Lamfalussy procedure and CESR's governance, respectively. It is argued that the Lamfalussy procedure lacks continuity in *selection* of norms and is unlikely to be a regulatory system for EU securities regulation as such. As for CESR's governance, the chapter argues that CESR's governance lacks the cybernetic features of *norm selection* in every aspect of regulation, although its persuasive network procedures may secure practical control over *effectuation* of the norms especially in administration and supervision by national regulators. However, this form of governance is *governance sans regulation*, and thus falls short of being a cybernetic system.

The findings of this thesis seem to suggest that regulatory convergence is not supported by a systemic structure, at least in the cybernetic sense. Hence, regulatory convergence, if it can be achieved, would have to be achieved in a more fluid and diffuse governance framework consisting of CESR's procedural framework and the patchwork of primary Directives, Commission Regulations and Commission Directives.

In the absence of a cybernetic system for regulatory convergence in EU securities regulation, the likelihood is that national regulations would diverge as there are many incentives for divergences discussed in chapter 5.

### **3. The Theoretical Support for an EU Securities Agency**

This thesis did not proceed by starting with a policy recommendation for instituting an EU agency for securities regulation, and then providing justifications for it. Instead, it attempted to take an objective look at what "regulatory convergence" means, and proposed to examine and unpack this concept into four constituent parts. The conclusions were then drawn from

the application of cybernetic analysis to the features of the current regulatory framework. From these conclusions, the cybernetic “deficits” of the current regulatory framework are discerned, and chapter 6 made a recommendation as to how the regulatory framework may be modified in order to achieve cybernetic features for regulatory convergence. As the main problem is one of multiple *selection* of norms, it is proposed that perhaps institutionalisation of regulatory convergence at the EU level is necessary, as such institutionalisation will produce an overall framework of rules and norms for the entire system.

It is then argued that such institutionalisation could be brought about by having a dedicated organisation for it, as organisations theory points out features of organisations that would facilitate such institutionalisation of rules and norms. Further, the setting up of dedicated organisations to regulate specific areas also seems to be a dominant methodology in EU governance.

Chapter 6 proposes that CESR seems to be an apt outfit to be institutionalised as an EU securities agency. However, CESR still needs to co-opt the national regulators in an overall systemic approach to EU securities regulation. The chapter inquires into the Competition regulation model and the model of the European System of Central Banks to ascertain how these models achieve high levels of centralisation while co-opting national competencies. The lessons learnt from these models suggest that CESR should have the power of *selection* of norms for the administration, supervision and enforcement of EU securities laws, and CESR should also have actual *effectuation* over the authorising, supervising and enforcing against entities with pan-EU or cross-border operations or effects. National regulators should be responsible for *effectuating* purely domestic administration, supervision and enforcement. National regulators should also exist in a network for advisory and information feedback



functions vis a vis CESR. Such a model is a form of “decentralised integration”<sup>8</sup> where an EU body maintains control over *selection* of norms but *effectuation* may be dispersed and delegated, with the EU body maintaining control through the use of network and information structures.

The setting up of an EU agency in an area of shared competence such as securities regulation, is likely controversial, especially where issues of democratic deficit and legitimacy in governance are concerned. The theoretical support for the establishment of an agency does not mean that such establishment may be supported in policy. Chapter 6 suggests how, relying upon Scharpf’s thesis of output legitimacy, the perception of democratic deficit may be reduced if CESR acts as the EU agency for securities regulation. However, the policy drivers of whether an agency is to be set up or not is beyond the scope of this thesis.

#### **4. The Wider Context and Future Directions**

The FSAP’s hypothesis of creating an Internal securities market through regulatory convergence may arguably be put to a proper test if regulatory convergence is pursued with commitment. This thesis suggests that a rigorous pursuit of regulatory convergence should be based on adopting a systemic structure in designing regulatory features to achieve regulatory convergence. These systemic features may be found in examining the cybernetic system model. It arguably defeats the purpose of regulatory convergence if there is no systemic structure to support it, or that it is left to diffuse and fluid forms of governance to navigate towards regulatory convergence, as in both cases, the achievement of regulatory convergence may be reduced to only a possibility.

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<sup>8</sup> Edoardo Chiti, “Decentralisation and Integration in Community Administration: A New Perspective on European Agencies” (2004) 10 ELJ 402.

The institution of a systemic structure, primarily by establishing CESR as an EU securities agency, could be a useful learning experience in EU governance. The agencification of CESR is capable of being *theoretically* supported, and goes towards proving a wider objective: the link between legal and market integration in the EU. This question is left open by a leading study in EU securities regulation in 2004, which argues that there is insufficient evidence that legal integration is key to market integration, although it may be one of the factors in improving market integration.<sup>9</sup> If a committed approach is taken to adopt a cybernetic system towards regulatory convergence in EU securities regulation, perhaps the extent of market integration can be measured in due course, to estimate the extent to which legal integration *really* contributes to market integration. It may however be argued that the extent of the effects that legal integration would have on market integration depends on the nature of the sector concerned. Securities regulation is an area where technical standards matter, and capital mobility, especially in the wholesale sector, is desired. Hence, such a sector may be more amenable to legal and market integration. On the other hand, any finding of a connection between legal and market integration in securities regulation may provide policy guidance for other issue areas, especially if issue areas may involve similar features such as the domination of wholesale commercial or financial elements. It would be too early to dismiss the need to find the extent of connection between legal and market integration, or to regard any finding in this respect as merely confined to one issue area. The main direction for future research could lie in establishing the link between legal and market integration, based on empirical evidence supporting or disproving theory.

CESR is already poised to become an agency, as it has systematically instituted interpretative guidelines for securities laws, and has assumed a significant position in coordinating and monitoring national regulators in the law in action. It may even be politically unacceptable to allow CESR to continue perpetuating its role in regulatory convergence without a formal

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<sup>9</sup> Eilis V. Ferran, *Building an EU Securities Market* (Cambridge: Cambridge University Press 2004).

institutional status which would entail more transparency, accountability and perhaps democratic support. The pursuit of regulatory convergence does entail some transfer of erstwhile national competencies to EU-level competencies, and there would always be political or social resistance. Scharpf<sup>10</sup> is of the view that, recent citizen scepticism of expanding EU level competencies lies in the problem that citizens are used to having nationally elected officials solve the country's problems, and if the problem-solving capability of Member States is being undermined because of market integration, this results in unease and discomfort among citizenry. The gap that is needed to be bridged is between the unease at the reduction of certain national competencies and the hope in EU-level competencies in substitution. If the EU could take over such problem-solving and provide positive results and economic growth, then perhaps the path dependence on national institutions may be mitigated. However, building trust in EU competencies may be a chicken-and-egg problem, that EU level competencies are not trusted until results are proved, but results may only be achieved once the EU is able to exercise those competencies in question. The theoretical findings in this thesis may suggest that one has to start somewhere, and perhaps it is time to identify whether the lack of systemic structures for legal integration is a *problem* for market integration, despite the theoretical acceptance of diffuse theories of governance.

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<sup>10</sup> Fritz Scharpf, *Governing Europe* (Oxford: OUP 1999).

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