1

Overview and introduction to terminology

A The FSAP

Promoting the smooth and efficient flow of capital from savings to investment is a policy priority for Governments around the world. An important aspect of this policy agenda is the development of securities markets to facilitate access to capital by issuers.

Within the EU enthusiasm for improving issuers' access to capital is entwined with interest in building a properly integrated pan-European financial market. Such a market, it is believed, will offer a range of benefits including lower capital costs for issuers and better returns for investors that should, if projections are right, impact positively on the real economy.

The Financial Services Action Plan (FSAP) was an attempt by the European Commission to equip the Community better to meet the challenges of monetary union and to capitalise on the potential benefits of a single market in financial services.[1] The FSAP set out a detailed action plan for the adoption by 2005 of legislative measures to support a single, integrated financial market in which a strong securities market was envisaged as a major component.

The FSAP led to extensive change in securities market regulation: new laws; new law-making processes; and more attention to the mechanisms for the supervision of securities market activity and enforcement. With the FSAP nearing completion, it is now a good time to take stock of what has been achieved, and to identify challenges that lie ahead. Paradoxically, the programme of activity that was heralded by the FSAP is vulnerable to charges of both excess – that there has been intervention that is liable to inhibit legitimate business activity – and underachievement – that the reality of a common regulatory system, embracing common supervisory standards and practices as well as common legal rules, is still much further off than some political rhetoric might suggest.

[1] European Commission, *Financial Services: Implementing the Framework for Financial Markets: Action Plan* (COM (1999) 232).

Concern about what has been created by the FSAP is evident in a number of recent reports.[2] This book shares some of the concerns and identifies problems in three key areas: the balance between regulatory harmonisation and diversity, where some recent changes may have shifted the balance too far in favour of a standardised approach; excessive reliance on regulation as the first-choice policy tool at the expense of due attention to supervision; and insufficient regard to the consequences of EU regulation on the global competitiveness of its securities markets.

Although this book acknowledges some serious deficiencies in the recent developments, it does not see a pan-European securities market regulator and supervisor as offering a superior way forward. The preferred option is to build upon and refine the existing regulatory and supervisory framework. The book suggests that a dedicated pan-European securities regulatory and supervisory agency would not solve existing problems and that it could generate a host of new concerns about transparency, accountability, efficiency and effectiveness.

The FSAP was wide-ranging in scope but this book concentrates particularly on how the new legal framework will affect issuers' access to the primary and secondary securities market. Since any market would struggle to grow without a good supply of its basic commodities, the attractiveness, or otherwise, of a securities market to issuers, that is to the providers of fundamental securities, is a crucial determinant of its likely success. In line with international norms, disclosure is the primary regulatory strategy within the EU for regulating issuers' access to securities markets. The essays in this book therefore pay special attention to the new issuer disclosure regime. Examining such an intrinsically important area provides an opportunity to assess the achievements and failings of the FSAP more generally.

B General background to the development of the FSAP

A properly integrated financial market is one where capital can move freely within the economic area and in which investment services are gen-

[2] HM Treasury, *Flexibility in the UK Economy* (March 2004), p. 25, available via www.hm-treasury.gov.uk (accessed April 2004); Securities Expert Group, *Financial Services Action Plan: Progress and Prospects* (Final Report, Brussels, May 2004), available via http://www.europa.eu.int/comm/internal_market/en/finances/actionplan/docs/stocktaking/fasap-stocktaking-report-securities_en.pdf (accessed May 2004).

erally available. Free movement of capital implies the removal of barriers hindering issuers from raising capital from wherever they like within the economic area and investors from investing anywhere they like within the economic area. Freedom to provide services, and the associated freedom for people to establish businesses, imply the removal of barriers hindering financial intermediaries and market infrastructure providers (trading systems, settlement services and so forth) from operating throughout the economic area. Free movement of capital, services and persons are freedoms enshrined in the Treaty Establishing the European Community.[3] This Treaty provides the base for Community legislative competence in the economic field.

The creation of a strong, deep securities market to facilitate the free movement of capital and pan-European provision of investment services and products was on the policy agenda of the central institutions by the 1960s[4] but it was not until 1979 that the first legislative measure directly relating to issuers was adopted – a Directive on admission to official listing.[5] The fairly narrowly confined area of admission of securities to official listing remained the focus for centralised legislative activity during the first part of the 1980s.

A significant expansion in securities laws emanating from the central institutions resulted from the drive towards the establishment of the single market that was launched by the European Commission in the mid-1980s. The Directives adopted during this second phase of securities law-making within the EU included the Investment Services Directive,[6] often described as the cornerstone of EU securities regulation,[7] and the Public Offers of Securities Directive.[8] These Directives made use of the passport

[3] Title III.

[4] Report by a Group of Experts, *The Development of a European Capital Market* (Brussels, European Commission, 1966) (Segré Report), discussed in N. Moloney, *EC Securities Regulation* (Oxford, Oxford University Press, 2002), pp. 22–5. This paragraph draws heavily on Moloney's work.

[5] Council Directive 79/279/EEC of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing, OJ 1979 No. L66/21.

[6] Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ 1993 No. L141/27.

[7] European Commission, *Upgrading the Investment Services Directive* (COM (2000), 729); Moloney, *EC Securities Regulation*, p. 24.

[8] 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 No. L124/8.

concept.[9] The essence of the passport concept is that issuers, investment firms and market structure providers authorised in one Member State can gain access to other Member States without the need for further, local regulatory approvals. The passport concept was conceived as being crucial to the development of a properly integrated pan-European financial market in which issuers, investment firms and investors could operate freely and seamlessly, unimpeded by national boundaries.

Despite these developments a new mood of pessimism took hold during the latter part of the 1990s. There was a widespread view that insufficient had been done to equip the European Community to make the most of monetary union and to capitalise on its benefits.[10] The European Commission felt that Europe was still a long way from realising the potential benefits of the single market in financial services.[11] Although some progress had been made in the previous decade, the passage of time had exposed deficiencies in laws that often had been political compromises representing the lowest common denominator on which the Member States could agree. Member States retained much discretion to add to the centralised requirements and to interpret them in different ways, and this practice was felt to hinder the realisation of an effective integrated market. One of the more obvious failings of the existing regime was the passport provision for securities offerings.[12] Host Member States could require

[9] P. Clarotti, 'The Completion of the Internal Financial Market: Current Position and Outlook' in M. Andenas and S. Kenyon-Slade (eds.), *EC Financial Market Regulation and Company Law* (London, Sweet & Maxwell, 1993), pp. 1–17, provides an overview of the use of the passport concept across banking, securities and insurance law. He notes (at p. 8) that Council Directive 85/611/EEC relating to undertakings for collective investment in transferable securities (UCITS), OJ 1985 No. L375/3 was the first securities law Directive to make use of the passport concept. See also, E. Lomnicka, 'The Internal Financial Market and Investment Services' in ibid., pp. 85–6.

The landmark decision of the European Court of Justice in Case 120/78, *Rewe-Zentrale AG* v. *Bundesmonopolverwaltung für Branntwein* (*Cassis de Dijon*) [1979] ECR 6 marked a general shift in the internal market harmonisation programme, away from the imposition of the same standards in all Member States to mutual recognition regimes whereby Member States were obliged to accept compliance with the regulatory requirements of other Member States: G. Hertig, 'Imperfect Mutual Recognition for EC Financial Services' (1994) 14 *International Review of Law and Economics* 177, 178.

[10] Moloney, *EC Securities Regulation*, pp. 26–32 discusses the background to the FSAP and the Lamfalussy Report; R. S. Karmel, 'Reconciling Federal and State Interests in Securities Regulation in the United States and Europe' (2003) 28 *Brooklyn Journal of International Law* 495, 529.

[11] European Commission, *Financial Services: Building a Framework for Action* (COM (1998) 625), p. 1.

[12] Ibid., p. 9.

issuers seeking to rely on the passport to translate the prospectus into the local language and to add additional information for local investors. These additional requirements added significantly to the transaction costs of a cross-border issue making the passport route unattractive to issuers with the result that for most practical purposes it became irrelevant.[13] The passport regime for investment services providers was plagued by similar problems in that passported firms were generally subject to host Member State conduct of business rules, which were not harmonised and which could therefore differ from State to State.[14]

It was thus largely out of a desire to redress the deficiencies of the existing regulatory regime as a pan-European integration mechanism that the FSAP was born. This marks it out as unusual. Revisions of securities laws are more typically driven by market collapses or major scandals that unmask deficiencies in existing law and generate strong political imperatives for Governments to be seen to be moving quickly to correct the mistakes of the past and to repair investor confidence.[15] Although various crisis-response measures were grafted onto the detail of the FSAP during its life, its priorities and principles were originally shaped in a different environment. This is a relevant consideration in assessing the achievements of the FSAP.

C From FSAP to Lamfalussy and CESR

One of the complicating aspects of studying the development of securities law and supervision within the EU is the bewildering array of acronyms

[13] A. B. St John, 'The Regulation of Cross-border Public Offerings of Securities in the European Union: Present and Future' (2001) *Denver Journal of International Law and Policy* 239.

[14] European Commission, *Financial Services: Building a Framework*, pp. 11–12; European Commission, *Upgrading*, p. 3 ('the usefulness of the single passport has been impaired by extensive exemptions from its scope and widespread application of host country requirements'). Generally, M. G. Warren, The Harmonization of European Securities Law' (2003) 37 *International Lawyer* 211, 213–15.

[15] S. Banner, 'What Causes New Securities Regulation? 300 Years of Evidence' (1997) 75 *Washington University Law Quarterly* 849; F. Partnoy, 'Why Markets Crash and What Law Can Do About It' (2000) 61 *University of Pittsburgh Law Review* 741; B. A. K. Rider, 'The Control of Insider Trading – Smoke and Mirrors!' (2000) 19 *Dickinson Journal of International Law* 1, 31–5; E. Ferran, 'Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model' (2003) 28 *Brooklyn Journal of International Law* 257.

and other terms whose meaning is not immediately obvious.[16] Alongside 'FSAP', there are two other terms whose significance is such that they merit an early introduction.

The first is the 'Lamfalussy' law-making process. In 2001 the process for making securities laws within the EU was overhauled with a view to providing a more nimble legislative machinery that would be better adapted to the pace of global financial market change.[17] The need for change in the legislative process, and a model for its achievement, had been laid out in a powerful report from an influential committee headed by Baron Alexandre Lamfalussy, a Belgian central banker and distinguished economist.[18] It has been said of Baron Lamfalussy's achievement in this field that he is one of very few people outside the world of politics to have an eponymous legislative process.[19]

The Lamfalussy process was applied to many of the new EU laws that are considered in this book. However, those laws were first formally proposed in the FSAP, an initiative which preceded the adoption of the new legislative process. This sequence of events deserves emphasis. Whilst it is legitimate to ask whether the adoption of the Lamfalussy process has helped produce better-quality laws governing securities market activity within the EU, it is important also to bear in mind that the Lamfalussy process came late, after certain important strategic policy decisions had been made and, crucially, after the timetable for the adoption of the FSAP had been set. These considerations must qualify whatever blame for the substantive quality of the recent laws is laid at the feet of the legislative process.

The second significant term is 'CESR', which stands for the Committee of European Securities Regulators. This Committee, which comprises the heads of the securities regulators from the EU Member States and certain

[16] 'The Tower of Babble', *Economist*, 2 August 2003, p. 45 notes that this is a general problem within the EU, it being a key EU strategy, honed over many years, 'to avoid calling anything by a name that might let an outsider guess what is being talked about'.

[17] The adoption of the new legislative process is considered in detail in ch. 3.

[18] *The Regulation of European Securities Markets: Final Report* (Brussels, 15 February 2001), in which *The Regulation of European Securities Markets: Initial Report* (Brussels, 9 November 2000) appears as Annex 5. The reports are available via http://www.europa.eu.int/comm/internal_market/en/finances/general/lamfalussyen.pdf (accessed April 2004). Baron Lamfalussy was the one-time general manager of the Bank for International Settlements, and president of the European Monetary Institute, the forerunner of the European Central Bank.

[19] P. Norman, 'Brussels Wise Man 'Satisfied' With Reform', *Financial Times*, 2 June 2003, FT Fund Management, p. 4.

other European countries, was established as part of the adoption of the Lamfalussy process.[20] CESR performs a range of functions, including participating in the process whereby laws are made and helping to develop pan-European consistency in supervisory practices and policies.

D EU securities law – explanation for terminological approach

It is now widespread practice for legal instruments relating to the securities market that emanate from the central institutions to be described as "EU" measures. Thus, for example, the index to regulation on the European Commission's website proclaims that 'EU Directives ensure the development of a single securities market for both new issues and trading of securities.'[21] Likewise CESR's website describes it as an advisor to the Commission 'in particular in its preparation of draft implementing measures of EU framework Directives in the field of securities'.[22] The strict technical position is that securities laws are made within the legal framework of the European Community (EC, formerly European Economic Community or EEC), which is a Community within the common structure of the European Union.[23] The EU, as such, has a limited role, although this will change if the Constitutional Treaty for the EU is finally adopted because this is intended to confer legal personality and powers on the EU and to provide for it to succeed to all of the rights and obligations of the EC.[24] This book generally follows the looser practice that has developed in the securities field but references are made to EC law or to the EC Treaty where technical accuracy is demanded by the context.

[20] See further ch. 3.
[21] http://europa.eu.int/comm/internal_market/securities/index_en.htm (accessed April 2004).
[22] *CESR In Short*, statement on CESR website, http://www.cesr-eu.org/ (accessed April 2004).
[23] J. Shaw, *Law of the European Union* (3rd edn, Basingstoke, Palgrave Macmillan, 2000) pp. 4–11.
[24] Draft Treaty Establishing a Constitution for Europe (18 July 2003), OJ 2003 No. C169/1. A heavily amended version of the Constitution was agreed by the EU Heads of State/Government in June 2004. The Constitution will now need to be approved unanimously by Member States. Various Member States have indicated their intention to hold a referendum on the issue. Since the process of securing all of the necessary approvals is likely to be time-consuming and politically contentious, with no guarantee of eventual success, the essays in this book refrain from speculating on how the new constitutional framework may affect securities law.

2

Law's role in the building of an integrated EU securities market

A Scope of chapter

Two fundamental, and interlinked, issues relating to the development of an integrated EU securities market are considered in this chapter.

The first concerns the policy objectives that underpin the interest of the central EU institutions and Member States in the development of an integrated securities market, the extent to which these policy objectives have already been achieved, and the forces that have contributed to that achievement. A pan-European, fully integrated financial market, of which a securities market is an important component element, represents a key part of the political and economic vision for the EU. Establishing a common market for certain sorts of economic activity was where the massive structure that is now the European Union all began in the 1950s.[1] If originally this was conceived as a post-World War II plan to avoid further armed conflict, by the 1960s the economic advantages that could be secured by the creation of a large trading bloc were becoming highly valued in their own right.[2] Promotion of economic integration has continued to occupy a central position in EU policy-making down to the present day. With regard to financial markets, the integration programme received a massive boost at the end of the 1980s with the formal commencement of the process for the realisation of economic and monetary union.[3] This process produced the Maastricht Treaty, which paved the way for the establishment of the European Central Bank and resulted in the introduction of the Euro

[1] With the establishment of the European Coal and Steel Community by the Treaty of Paris in 1951: S. Weatherill and P. Beaumont, *EU Law* (3rd edn, London, Penguin, 1999), p. 2. Generally on the origins of the EU: J. Gillingham, *European Integration 1950–2003: Superstate or New Market Economy* (Cambridge, Cambridge University Press, 2003), pt 1.
[2] Weatherill and Beaumont, *EU Law*, p. 5.
[3] Ibid., pp. 767–83.

as a unit of account in 1999 and its adoption in 2002 as the physical national currency in the countries of the Eurozone.[4]

From an economic perspective, the policy of promoting the development of an integrated securities market that combines fragmented pools of capital in a stronger and deeper single source has much to commend it. Evidence reviewed in this chapter strongly suggests significant linkages between financial market development and economic growth. The existence of a strong securities market matters to financial development and hence to economic growth because banks and securities markets are complementary sources of finance and each has potential advantages over the other depending on the type of economic activity for which funding is being sought.

In recent years, the European corporate sector has shifted away from its traditional reliance on bank-based financing towards greater use of the securities markets. European investor interest in securities markets has also grown. However, particularly on the retail side, investor interest is still largely fragmented along national lines and thus, despite some movement in that direction, it cannot yet be claimed that the EU has a fully integrated single securities market. That the single securities market is not yet a reality is significant because it implies that there remain important policy questions about tools that might be put to use to complete the building project.

Regulation, in its narrow rule-making sense, is a favoured EU policy tool. It is therefore appropriate to pay particular attention to the historical contribution made by EU regulation towards the development of securities market activity within the EU, and also to consider its potential further contribution towards completion of the task. The role of regulation is the second key issue considered in this chapter but the discussion of it is preceded by a strong caveat to the effect that the development of securities market activity is contingent upon a range of variables and is not simply a creature of central planning.

In contemporary law and economics scholarship there is much discussion of the relationship between law and financial development, a central question being whether law drives financial development or follows after it to regularise and formalise the norms that market participants have already come to expect as a matter of established practice. Superficially,

[4] The origins of European Monetary Union (EMU) are reviewed by J. Dermine, 'European Capital Markets: Does the Euro Matter?' in J. Dermine and P. Hillion (eds.), *European Capital Markets with a Single Currency* (Oxford, Oxford University Press, 1999), pp. 1–30 and D. Gros and K. Lannoo, 'EMU Monetary Policy and Capital Markets', ibid., pp. 33–75.

this debate appears relevant in the context of EU securities market regulation for two reasons. First, in the rhetoric often seen in EU policy discussions relating to the development of a single securities market, legal changes are frequently described as having a creative effect. Taken at face value, such commentary appears to suggest that historical study of the ways in which the EU has used regulation to advance its single market goals could usefully inform the wider debate on the relationship between law and financial development. However, this chapter suggests that an examination of the EU's record in regulating securities markets from this perspective is likely to disappoint. Stripped of its rhetoric, historically the EU's agenda for securities market regulation was mainly concerned with the task of dismantling barriers to doing business or investing on a cross-border basis. As such, it had a different focus from, and therefore tells us little that is useful to, the general debate on law as a creative force since that debate is essentially concerned with the contribution that credibly enforced investor protection laws can make to financial development. Even narrowing down the inquiry to aspects of established EU law that can properly be regarded as attempts to improve pan-European investor protection, the chapter suggests that there is little concrete evidence to link the growth in securities market activity that has taken place within the EU in the past two decades to the existence of these laws.

The second reason why the general 'law matters' debate could be relevant to the analysis of EU securities market regulation is its normative dimension. As the need for barrier-dismantling laws has diminished, the attention of EU policy-makers has turned increasingly to investor protection issues,[5] a potentially worrying change of emphasis if looked at through the lens of the 'law matters' debate. That debate has failed thus far to establish convincingly that better-quality investor protection laws actually do promote securities market development or, even if a linkage is assumed, to pinpoint precisely which laws matter most in this respect. This uncertainty suggests that EU policy-makers should proceed cautiously in pursuing an investor protection regulatory agenda because they are, broadly speaking, shooting in the dark. Arguably they would do better to leave some room for continuing diversity between Member States with regard to investor protection laws. This alternative would not necessarily preclude a gradual shift towards common standards because it could allow for a process of de

[5] N. Moloney, 'Confidence and Competence: The Conundrum of EC Capital Markets Law' [2004] *Journal of Corporate Law Studies* 1.