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Abstract

This paper looks into the concepts underpinning the current generation of capital market integration directives, that follow the « Lamfalussy-approach «. In particular, we examine whether the Level 1-directives are based on minimum or maximum harmonization. We submit that the European lawmakers have failed to clarify this issue, thereby reducing legal certainty for the various stakeholders (suppliers, investors and supervisors alike). In addition, the adoption of yet a new harmonisation technique runs the risk of creating inconsistencies with the previous generation of financial market integration directives, adopted under the 1992 Internal market program. Finally, we look at how the Prospectus Directive and MiFID divide regulatory and supervisory powers between home and host state.

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Financial Market Integration in the Post-FSAP Era. In Search of Overall Conceptual Consistency in the Regulatory Framework

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Introduction

Rarely has one seen such a high pace of adoption of financial regulation at EU level as during the final stage of the Financial Services Action Plan (FSAP). The result is impressive, both in terms of quantity and as concerns the ability to stick to the time-schedule set forth in the FSAP. Though much regulation is still to come under the form of 'level 2'-rules, to be adopted by the European Commission, it is clear that the FSAP, backed by the Lamfalussy-process, has given a serious boost to the regulatory efforts aimed at the integration of capital markets in the EU.

Time has come to overlook the progress achieved over the last few years, and to examine whether all this new regulation actually will produce what it intended to : to create a truly integrated EU-wide financial market. From a legal point of view, an important precondition to analyse this question is to look at whether the legal foundations and principles on which the integration efforts rest, satisfy the requirements of consistency. Consistency in this respect relates to whether the different, interrelated directives adopt similar rules and principles, such as to create a level playing field between competing market actors and activities, and therefore to eliminate competitive distortions between Member States. The need to achieve consistency has often severely impaired the chances to have EU directives adopted, as was illustrated by the discussions on the regulation of trading venues in the draft directive on financial markets (MiFID), where the technicalities on pre-bid and post-bid transparency threatened to paralyse the adoption of the directive.

The need to ensure consistency also appears at a more general level. When carefully looking both at Directive 2004/39/EC on Markets in Financial Instruments (MiFID) and at the Prospectus Directive, on which we will focus our analysis, we can see some important modifications in the underlying legal principles, compared to the previous financial integration directives, adopted under the 1992 Single Market Programme. This was not only the case as concerns the predecessors of the mentioned directives, which at present have been abolished, namely the 1993 Investment Services Directive, the 1989 Public Offers Directive and the 1980 Listing Prospectus Directive. The same principles still underpin the regulatory framework for credit institutions under the 2001 Codified Banking Directive, as well as the 1985 UCITS-Directive. While these directives clearly were based on the paradigm of minimum harmonisation and mutual recognition, the present Prospectus and MiFID directives no longer express the idea of minimum harmonisation. The latter directives also modify the home-host country allocation of powers, *inter alia* by introducing new residual powers for the host state supervisory authorities, which did and do not exist under the Internal Market directives of the previous generation.

In the first part of this paper, we will examine to which extent the 'silent' modification of the underlying concepts in MiFID and the Prospectus Directive may affect the overall structure and consistency of the legal framework for financial market integration. We will in particular focus on the issue of minimum versus maximum harmonisation.

In a second part, we will analyse how modifications in the division of powers between home and host state in the new directives are likely to have an impact on market integration. Attention will not only be paid to cross-border activities of investment firms and (regulated) markets, but also to transactional regulation (in particular

conduct of business rules) under the new directives, highlighting the main modifications compared to the ISD. A particular question in this regard is whether the allocation of powers in MiFID will stand the scrutiny of primary EC law, taking into account recent case-law of the ECJ. As for the Prospectus Directive, a critical issue is how the directive influences prospectus liability regimes, and whether additional regulation is needed in this area.

The Underlying Regulatory Concepts: From Minimum to Maximum Harmonisation or Something in Between?

It is well known that the regulatory paradigm underpinning the directives adopted under the 1992 Internal Market Programme consisted of, in line with the subsidiarity principle, regulating only at EU level what was necessary to create a climate of mutual confidence amongst Member States in the quality of each others' regulatory standards. The preambles to the main financial integration directives of the 1992 generation highlighted this approach by referring to 'necessary but sufficient harmonisation'.[1] This concept of so-called minimum harmonisation allowed Member States to maintain or introduce more stringent regulatory requirements towards domestic financial institutions, within the area covered by harmonisation. However, a degree of regulatory competition was introduced through the accompanying principle of mutual recognition: a Member State would have to balance its own regulatory interests against the risk of adverse competitive effects for its domestic financial industry by exceeding the common minimum standards. The potential for unwanted downsizing of regulatory standards was counterweighed by the fact that, in practice, the 'minimum' investor protection offered by the EU directives already reached a high level, particularly compared to pre-existing rules in many Member States. Moreover, maintaining high standards in regulation, either in prudential or in transactional regulation, was perceived in some jurisdictions as a factor of attractiveness of the financial system, more than as a deterrent. This 'competition for excellence' explained why the adoption of the first generation of financial market directives under the 1992 Internal Market Programme did not lead to a substantial decrease of regulatory standards in those Member States with strict regulation (e.g. United Kingdom).

The directives adopted under the Lamfalussy process seem to have departed from the 'minimum harmonisation' approach, but it is unclear which concept – if any – has replaced it, as both the preambles and the provisions of the directives remain largely silent on this issue. Part of the answer may reside in the Lamfalussy approach itself, with the use of level 1 'framework principles' and level 2 'technical implementation' rules. In particular within the scope of the rules harmonised at level 1, the mandate to further specify and implement the general standards through level 2-rules, suggests that level 2 rules are likely to be exhaustive in substance. This could be even more the case when use is made not of a directive but of a regulation as legal instrument for level 2 rules, the latter being directly applicable in the legal order of the Member States without further implementation.

However, we submit that the Lamfalussy approach is not, in itself, incompatible with the idea of minimum harmonisation. First, the Lamfalussy procedure does not automatically empower the Commission to adopt level 2 measures, but only to the extent it has received a mandate to do so in the framework directive. Consequently, the Lamfalussy procedure does not automatically result in detailed, exhaustive regulation at EU level, limiting or in fact even eliminating altogether the powers of Member States to regulate. Second, where a level 2 mandate has been given to the Commission in the framework directive, the terms of the mandate are often phrased as to empower the Commission to give 'minimum' execution to a general provision. This suggests that the mandate, even if it can result in a high level of detail, does not in itself preclude Member States from maintaining stricter requirements domestically. This conclusion also seems consistent with the philosophy of the Lamfalussy procedure. The multi-level approach in rule-setting did not intend to eliminate Member States' powers in the matters covered by substantive EU harmonisation, as they existed under the 'minimum harmonisation' directives. It was mainly devised as an answer to the rigidity of the institutional dimension in the law-making process at EU level, in view of the pace of developments in the securities industry. Speeding up the rulemaking process therefore can perfectly co-exist with keeping regulatory standards at EU level on a 'minimum but sufficient' level, where the level 2 rules would do no more than provide a more advanced level of detail of the 'minimum' principles laid down in the framework directives.

A further major concern voiced in the Lamfalussy-report, however, related to the perceived absence of clear EU-wide regulation on a large number of issues (such as prospectuses, conduct of business rules, etc.), which

[1] See, for instance, paragraph 6 of the preamble to the 2000 Codified Banking Directive (Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, OJ L126 26.05.2000 1-59); paragraph 52 of the preamble to the UCITS Directive (Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L375 31.12.1985 3-18); paragraph 3 of the Preamble to the Investment Services Directive (Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ L141 11.06.1993 27-46).

prevented the implementation of the mutual recognition regime.[2] This criticism seemed more closely related to the concept itself of minimum harmonisation, as one of its implications was to maintain fairly general, and often vague rules in the financial integration directives, which subsequently suffered from uneven implementation and divergent interpretations in the Member States. The remedy under the form of multi-level regulation clearly results, as the practice of MiFID and the Prospectus Directive demonstrates, in highly detailed and extremely technical rules, not only at level 2, but even at level 1, at least for politically more sensitive issues.[3] Once again, this approach is not in itself incompatible with the concept of minimum harmonisation, which would allow Member States to maintain more stringent domestic regimes for the actors and transactions under their jurisdiction, though it is true that its scope will in fact probably be substantially reduced by the detailed level 2-rules.

The issue outlined above obviously is not merely an academic one. It raises the issue to which extent Member States, when implementing the new generation of directives, will be obliged to loosen regulatory requirements in their domestic laws that are more severe than the directive. For instance, could a Member State maintain a more severe definition of what constitutes a 'public' offer of securities, under the form of a quantitative threshold of 50 solicited persons, instead of 100 under the Prospectus Directive?[4] Could a Member State impose more stringent prudential requirements for its domestic investment firms than those contained in MiFID? Could the home Member State impose more severe reporting requirements than those imposed by Article 25 MiFID and its implementing rules at level 2?[5]

Different approaches could be adopted with respect to this issue, bearing in mind that no clear answer is provided by the directives or by the Lamfalussy-system itself.

I. Maximum Harmonisation?

A first approach would entail that, in the absence of any enabling clause in the 'Lamfalussy generation' directives, comparable to the 'minimum harmonisation' clauses in the 'generation 1992' directives, the harmonisation should be considered to have a maximum character.[6] This approach would not completely eliminate all flexibility at national level, as often level 2 mandates are formulated in the level 1 framework directives as 'minimum requirements'. Consequently, a Member State would still be enabled, within the confines of level 2 regulation, to be more severe than the EU rules. As a result, the former concept of minimum harmonisation would be substituted by a more restricted concept of minimum regulation at level 2, only applicable when expressly provided for in the mandate under the framework directive.[7] This would substantially reduce regulatory diversity amongst Member States, without altogether eliminating it.

If the harmonisation is deemed 'maximum', MiFID radically departs from the approach to harmonisation followed by its predecessor, the 1993 Investment Services Directive. It would also result in inconsistencies between the prudential regimes applicable to investment firms and to credit institutions. For the latter, the Codified Banking Directive would still allow for stricter rules at national level as regards prudential regulation, while this would not be the case for the authorisation requirements applicable to investment firms under MiFID. This is all the more surprising since the prudential requirements for both categories of financial institutions are largely similar in substance, in particular when it comes to assessing the quality of the internal organisation, the internal structure and the group environment of the supervised institutions. Finally, the divergent approaches

[2] Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (15 February 2001) (the Lamfalussy Report) 10.

[3] The regulation of pre-trade transparency for internalisation of orders amply illustrates this phenomenon: one can hardly consider these rules as merely 'high level principles'.

[4] See 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, OJ L345 31.12.2003 64-89 (the Prospectus Directive) Article 3 (2) (b), according to which the obligation to publish a prospectus does not apply to an offer of securities addressed to fewer than 100 natural or legal persons per Member State, other than qualified investors.

[5] At present, some Member States do indeed impose such stricter requirements onto their investment firms. Loosening these requirements would entail costly modifications to be made to the existing IT systems for the sake of reporting obligations.

[6] In its technical meaning, maximum harmonisation thus means that Member States are no longer empowered to impose 'superequivalent' standards: see J Herbst 'Revision of the Investment Services Directive' (2003) 11 J Fin Regulation & Compliance 211, 213.

[7] Sometimes, this qualification could be less explicit. See, for instance, the heading of Article 7 Prospectus Directive, which refers to 'minimum information'. Article 7 itself contains the mandate to the Commission to determine at level 2 the specific information which must be included in a prospectus, without, however, mentioning that this would be 'minimum' information. As the heading preceding an article is not legally binding, it remains unclear whether the information at level 2 would be a 'minimum', to be possibly completed by national regulation, or whether it would contain an exhaustive catalogue of information requirements, precluding a Member State from imposing a more extensive 'minimum scheme' in national law.

under MiFID and the CodifiedBanking Directive present the risk of disrupting the level playing field between both categories of financial institutions. A similar situation arises within the prudential regulatory framework for investment firms, as the provisions on regulatory capital are still based, at least in part, on 'minimum harmonisation'. This was not only true for the regime of solvency and other ratios which are still in force at present.[8] The 'minimum harmonisation' approach will also continue with the entry into force of the Directive on Regulatory Capital, which incorporates the Basel II-accord into EU law.[9] There does not seem to be a rational justification for allowing Member States to impose stricter capital requirements, while precluding them from exceeding the EU standards in other prudential matters as regards regulation of investment firms.

II. Minimum Harmonisation?

The opposite view holds that, in the absence of a clear provision in the new directives as to the 'maximum' character of the harmonisation, Member States remain free to enact more severe requirements into their domestic systems, as long as they do not conflict with the mutual recognition regime. Under this approach, Member States could exceed the level of EU regulation either at level 1 or level 2, even if the level 2 mandate would not be worded as a minimum mandate. As, in the Lamfalussy system, level 2 regulation is to be regarded as the further implementation of the framework principles adopted at level 1, the mandate given to the Commission to regulate at level 2 can never be wider than to further specify the rule under level 1. This specification at level 2 can, depending on the wording of the mandate, be either exhaustive or not. In both occurrences however, Member States would remain competent to add (technical) requirements to the standards set at level 2, assuming that they have the residual competence to exceed the level of harmonisation at level 1.

III. Between Minimum and Maximum Harmonisation: 'Effective Harmonisation'?

In recent discussions, the European Commission seems to have adopted a 'third way' to the underlying concept of harmonisation, namely a paradigm of 'adequate' or 'effective' harmonisation.[10] Though it is not yet clear what its precise significance is, the notion would refer to the *effet utile* or effectiveness-doctrine, as developed by the Court of Justice in the context of the implementation of directives into national law. According to this theory, the choice of means and methods left to Member States when implementing a directive should be such as to ensure the effectiveness of the result prescribed by the directive. This approach could possibly lead to reducing the powers of Member States to exceed the level of harmonisation, to those cases where additional regulation does not hamper the effective application of the directive. This seems to imply that the issue has to be decided on a case-by-case basis, depending on the matter subject to harmonisation. It is clear that such an approach, though pragmatic, is not likely to promote legal certainty, lacking transparency as to the areas where harmonisation has reached a 'maximum' character and those where Member States are still allowed to impose 'superequivalent' rules in national law.

As regards 'level 2' measures, the goal of achieving uniform application of certain standards across Europe, would make a stronger case for considering these rules as 'maximum' harmonisation. In the context of the draft level 2 directive under MiFID, the European Commission stresses that the level 2 directive establishes a 'highly harmonised' legal regime, designed to ensure the uniform application of the level 1 standards. It is therefore 'not intended that Member States and competent authorities should add supplementary rules to those strictly needed for the transposition of the implementing Directive, as this would be contrary to the goal of achieving uniform application'.[11] Some ambiguity remains, however, to the extent that the Commission does not refer to

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[8] See, e.g. Article 113 (1) of Proposal for Directives of the European Parliament and of the Council, Re-casting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions (18 October 2005) 12890/05 (the Recast Codified Banking Directive), as regards limits on large exposures. No similar 'enabling clause' has however been maintained for the 8% solvency ratio when use is made of the standardised approach to contain credit risks.

[9] See Article 9 (1) of the Recast Codified Banking Directive (n 8).

[10] For instance, the Background Note to the Draft Commission Directive implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive (the Draft level 2-Directive) s. 2.2, uses the notion of 'adequate' harmonisation without, however, providing more guidance as to its significance. See <http://europa.eu.int/comm/internal_ market/securities/docs/isd/dir-2004-39-implement/dir-backgroundnote_en.pdf>.

[11] See the Background Note (n 10) s. 2.2 *in fine*.

'maximum' harmonisation; Nor does the Commission formulate a strict prohibition for Member States or competent authorities to maintain additional rules compared to the level 2 standards.

IV. Conclusion

We can conclude from the above developments that different arguments suggest that MiFID and the Prospectus Directive do not embrace the principle of 'maximum harmonisation', although its actual impact may be mitigated in fact by the high level of detail in standards set at level 2. This approach seems more consistent with the general system of the Treaty, and the division of regulatory powers between the EU institutions and Member States. To the extent that a directive prescribes a specific result to be attained, it will generally not be contrary to the directive for a Member State to maintain or introduce more stringent regulatory standards. Provided that a Member State duly applies the mutual recognition regimes by not applying its stricter standards to incoming services, the mere existence of a framework directive does not in itself preclude that Member State from maintaining such stricter rules, and, consequently, does not hamper the effectiveness of the directive. This conclusion can be supported by the legal foundation of the financial integration directives in Article 48 EC: harmonisation of national laws, whether through framework directives or through detailed level 2 regulation, is not an objective in itself, but only serves as a means to effectively realise the economic freedoms of the Treaty.[12] Therefore, it can be submitted in line with the general principle of subsidiarity that maximum harmonisation could only be imposed at EU level when it is necessary to achieve the aim of market integration. A clear demonstration of this necessity being absent in the directives (or their preamble), Member States should therefore retain competence to adopt stricter rules in the purely domestic confines of their national laws, as long as this does not conflict with the Treaty freedoms. Only when stricter rules at national level amount to a restriction to the (outbound) cross-border free movement of a domestic enterprise, they would have to satisfy the general good-test in order to be permitted under the Treaty. The Court's approach in *Alpine Investments*[13] showed some leniency to Member States in this regard, in the sense that maintaining the confidence in domestic financial markets could justify possible restrictions, *in casu* a prohibition to cold call potential clients in other Member States, on outgoing financial transactions. It remains unclear, however, whether the Court would maintain a similar flexibility in the presence of detailed harmonised rules.

The impact of the 'minimum harmonisation' paradigm will most probably be mitigated in practice by different elements. First, it is clear that the level 2 implementation rules are devised at a high level of investor protection and of technical detail, which will concurrently reduce the likelihood of more strict regulation at national level.[14] This is amplified by the fact that 20 out of the 67 provisions of MiFID are caught by mandates for further refinement at level 2.[15] Second, though labelled 'high level principles', many provisions in the framework directives also reacha high level of detail and technicality, which reduces flexibility for Member States in the implementation of these objectives into their national laws. Nevertheless, it may still be expected that numerous practical problems will arise in the stage of implementation of the directives at national level. In any case, the mere submission by commentators that the present generation of financial integration directives adopts the paradigm of 'maximum' harmonisation[16], is not supported by the provisions of the directives, the characteristics of the Lamfalussy regulatory structure or the general system of division of powers between the EU and the Member States.

Division of Regulatory Powers Between Home and Host State

Contrary to the uncertainty surrounding the level of harmonisation under the Lamfalussy-generation directives, the mutual recognition regime that prevailed under the directives of the 1992 Internal Market Program has been maintained and further consolidated. Indeed, the Lamfalussy report stressed the need to strengthen the mutual recognition regime, in order to avoid duplication of regulation and controls in cross-border activities.

[12] Compare ECJ, Case C-222/02 *Peter Paul and others v Bundesrepublik Deutschland* (2004) ECR I-9425 para. 36, where the Court held that the harmonisation directives primarily served the objective of market integration.

[13] ECJ, Case C-384/93 *Alpine Investments v Ministerie van Financiën* (1995) ECR I-1167 para. 42-44.

[14] See also J Herbst (n 6) 213, who points in this respect to 'maximum harmonisation' in substance, i.e. reaching a high level of substantive convergence, if not identity between the Member States.

[15] See B Sousi 'La procédure Lamfalussy à l'épreuve de la directive concernant les marchés d'instruments financiers' (2004) 2 Euredia 209, 214.

[16] See, for instance, PM Boury and R Panasar 'The Prospectus Directive: Creating a Single European Passport' *PLC Global Counsel Equity Capital Markets Handbook 2004/05* 17.

MiFID and the Prospectus Directive widen the scope of mutual recognition and of the home country control rule in different respects. However, several areas still remain outside the ambit of the rule, while both directives also appear to widen the residual powers of the host state supervisory authority in emergency situations. We will examine this more in detail for MiFID and the Prospectus Directive separately.

Home-Host Country Regulation and Supervision under MiFID

Prudential Regulation of Investment Firms

The extension of the mutual recognition regime under MiFID compared to the former regime of ISD, has taken place mainly through widening the scope of the notion of ‘investment services’ and ‘financial instruments’. As regards investment services, the upgrade of investment advice from non-core to core investment service, means that all specialised investment advisers will need an authorisation as investment firm. On the other hand, they will also benefit from the European passport regime. The inclusion of the operation of an MTF in the list of investment services, means that an investment firm will be able to use its European passport to extend its activities asan MTF-operator in other Member States.[17]

The extension of ‘financial instruments’ mainly covers commodities derivatives, including weather or climate derivatives and emission trading rights. The extension will not only cover the brokerage activities in these instruments, but also portfolio management or investment advice relating to it.

The prudential regime applicable to investment firms has not undergone other substantial modifications, except for the residual supervisory powers of the host state, which did not receive any particular attention during the negotiations and discussions on the draft directive. Under the ISD regime, prudential supervision was of the exclusive competence of the home country supervisor. The rule was considered to be fundamental for promoting market integration, by eliminating the costs and burdens of duplication in supervision.

Under the ISD regime, Article 19 provided for a possible exception to the home country rule in cases of (possible) threat to the protection of investors in the host country by an investment firm authorised and supervised in another Member State. However, a detailed analysis of the provision made it clear that the drafters of ISD had mainly effected a ‘cut and paste’ operation from the Second Banking Directive, which in the end proved to be ineffective in the context of ISD. Indeed, Article 19 provided for a residual power of intervention by the host state competent authority, to be exercised after consultation of the home state authority, in cases where the investment firm did not comply with the provisions in the host state adopted ‘pursuant to those provisions of [the ISD] which confer powers on the host Member State’s competent authorities’. The latter condition could not refer to any competence in the area of prudential supervision, since the ISD had not conferred any power to the host state in that respect, contrary to the Second Banking directive, where the host state prudential authority remained in charge of the supervision of branch liquidity.[18] The reference to a competent authority in Article 19 ISD could also refer to the authorities in charge of supervising conduct of business rules or of regulated markets, to which the investment firm could seek admission in the host Member State. However, it was doubtful whether ISD had to be interpreted in such a way as to reducing the discretion of the host state authorities in exercising these supervisory powers to an incoming investment firms, by subjecting it to prior consultation with the home state prudential authorities. We submitted that Article 19 ISD eventually proved to be meaningless, given the absence of residual prudential powers in ISD, by contrast with the situation under the Second Banking Directive.[19]

The drafters of MiFID seem to have been conscious of this problem, as Article 62 of MiFID obviously widens the scope of the host state’s competent (i.e. prudential) authority. The procedure to follow before the host state authority can take ‘precautionary measures’ has remained unchanged compared to ISD: before intervening, the host state competent authority should refer to its home state homologue for adequate measures to be taken. Only when this referral does not produce satisfactory results (either because the investment firm fails to comply with the measures ordered by the home state authority, or because the home state authority has failed to intervene), the host state authority is empowered to take the ‘precautionary measures’ necessary to protect its domestic investors.

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[17] See also F Buisson ‘La directive sur les marchés d’instruments financiers: quels enjeux pour la protection des investisseurs et le maintien de l’intégrité du marché?’ (2004) 2 Euredia 237, 243.

[18] Article 27 Codified Banking Directive. See also C Biancheri ‘The Co-operation amongst Supervisory Authorities under the Investment Services Directive’ in G Ferrarini (ed) *European Securities Markets. The Investment Services Directive and Beyond* (Kluwer Law International 1998) 367.

[19] See for more details M Tison ‘The Investment Services Directive and its Implementation in the EU Member States’ in J Stuyck, F Abraham, and E Terryn (eds) *Financial Services and Financial Markets in Europe. Changes and Adjustments* (Leuven University Press 2000) 125, 148-149.

Contrary to Article 19 ISD however, Article 62 of MiFID now clearly indicates in which circumstances the above procedure will apply, namely in case of 'clear and demonstrable grounds for believing that an investment firm ...is in breach of the obligations arising from the provisions adopted pursuant to this Directive ...'. When the investment firm is active under the freedom to provide services, the provisions referred to are all of the competence of the home state, and include both authorisation requirements, prudential regulation and conduct of business rules. As far as branch activities in the host state are concerned, Article 62 (1) further specifies that the procedure applies for those provisions 'which do not confer powers on the competent authority of the host Member State'.

The provision consequently allows the host state supervisory authority to take up residual intervention powers, after consultation with the home state, within the – normally exclusive – sphere of competence of the home state in the matters for which it has received competence under MiFID, i.e. prudential supervision and compliance with conduct of business rules when acting under free provision of services. It will also apply to credit institutions providing investment services.[20]

As far as the host state is competent to exercise supervision under MiFID, e.g. for conduct of business through a branch in the host state, Article 62 (2) confirms the possibility for the host state supervisor to take all adequate measures to halt infringements of the rules, without any prior consultation of the home state supervisor. This competence does not suffer any restriction pursuant to Article 62 (1).

As a result, Article 62 (1) MiFID allows the host state to actually break through the home country control principle in cases where host state investor protection is under threat.[21] The procedure may prove to be adequate in situations where the home state supervisor fails to properly discharge its functions, and urgent intervention is needed to avoid major market disturbances or systemic crises. At present, the host state authorities did not have any legal basis for intervening in such situations, neither under ISD or under the general system of the Treaty, which indeed does not allow a Member State to intervene unilaterally against another Member State which is allegedly in breach of its (supervisory) obligations under EC law.[22]

Article 62 MiFID is not, however, without raising serious concerns. Even though the use of this competence is surrounded by different safeguards, such as a proportionality requirement (only 'the appropriate measures needed to protect investors' can be taken by the host country supervisor) and the prior consultation of the home state, it is not excluded that this provision will effectively weaken the home country rule, and to a certain extent reinstall duplication of supervision in a cross-border context. In order to avoid possible abuse of this residual clause, it will be up to the European Commission to closely scrutinise the use of this procedure. It may therefore be welcomed that the directive provides for immediate notification to the European Commission of all measures taken by the host state under this provision. In order to maintain a long-standing climate of mutual confidence amongst supervisory authorities, it may be preferable for a Member State to have recourse only to its residual intervention power as an ultimate remedy, and to foster as much as possible close co-operation with the home state.[23]

Finally, Article 62 MiFID highlights a further source of disparity between the supervisory systems created under the 1992 Internal Market Program directives, and the Lamfalussy-directives. This leads to the inconsistent result that, pursuant to MiFID, the host state supervisor is empowered to take precautionary measures against a credit institution authorised in another Member State solely as regards investment services provided in its territory, since the Codified Banking Directive does not allow to do so with respect to other banking services. Similarly, the UCITS directive still is, as far as the structure and investment rules of an investment firm are concerned, based on an exclusive competence of the home state, without any residual power for the host state. The lack of overall uniformity obviously is not likely to promote (legal) certainty.

Cross-border Activity of Markets

While the ISD still to a large extent granted legal privileges to 'regulated markets' under the form of the concentration rule and the possibility to organise remote access on a cross-border basis, MiFID aims at paving the way for competitive equality between different trading venues (either regulated markets, MTFs or internalisation by investment firms). The possibility for these markets to operate on a cross-border basis is essential both for enhancing market liquidity and for reducing transaction costs through economies of scale.

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[20] See Article 1 (2), fourth indent MiFID.

[21] A similar provision is contained in Article 61 (3) as regards activities of a (regulated) market in the host state through remote access.

[22] See, in the context of the Television Directive: Case C-11/95 *Commission v Belgium* (1996) ECR I-4115; Case C-14/96 *Denuit* (1997) ECR I-2785. Compare, with respect to the UCITS Directive, the Belgian *Fleming Flagship*-case: Conseil d'Etat (4 June 1997) (1997) Rev Banque 588; M Tison (n 19) 149-150.

[23] See also F Recine 'The New Framework for Cooperation between Supervisory Authorities in the Markets in Financial Instruments Directive' (2004) 2 Euredia 335, 361-362.

However, cross-border expansion is not unlimited, and supervision may still be fragmented between home and host state. The operating conditions moreover vary according to the type of market venue.

A *regulated market* will always be organised and operated by a market operator that is supervised by its home state authority. The legal structure of a regulated market, in particular the question whether or not it has legal personality, remainsa matter of national law. When legal personality has been attributed to a regulated market under national law, the (home) Member State will decide how the obligations imposed by MiFID as regards organisation and operation of the market are to be allocated between the market operator and the regulated market entity. Though not specified in the Directive, the regime of regulated markets seems to be based on the assumption that the market operator and the regulated market have the same home Member State, i.e. the state in which the market has its head office or registered office (in case it has legal personality). Indeed, the directive never contemplates the possibility of both being situated in a different Member State, nor does it refer to the possibility for the market operator to expand its activities across borders, for instance by setting up a regulated market in another Member State. By contrast, regulated markets have been given the possibility to grant access to their trading platforms in other Member States through remote access, providing them a 'European passport' for their trading services. This single passport regime, which already existed under ISD, has been further elaborated in Article 42 (6) MiFID. This provision obliges host Member States to offer appropriate arrangements to regulated markets of other Member States so as to facilitate access to and trading on these markets by remote members or participants established in the host country.

It is striking that MiFID does not label the cross-border activity of regulated markets as 'provision of services' in the sense of the EC Treaty, but merely stipulates an obligation incumbent on the host Member States to provide for 'appropriate arrangements'. This approach can probably be explained by the circumstance that regulated markets do not necessarily qualify as a (legal) 'person' to whom the Treaty freedoms apply. Nonetheless, the situation is in fact close to an actual single passport: the foreign regulated market can offer its trading services to local market participants without having to obtain any additional authorisation, and normally under the exclusive supervision of the home country. The cross-border activity of the regulated market that is not a separate legal entity could also legally be approached as a cross-border provision of services by the market operator.[24] In this perspective, MiFID actually provides for a European passport for market operators, allowing them to expand their services relating to the operation of regulated markets across borders.

The 'appropriate arrangements' regime for regulated markets is markedly less developed than for investment firms, which have been the subject of detailed harmonisation. First, MiFID does not provide for any branch establishment regime for regulated markets or, as the case may be, the market operators. Thus, if a regulated market were to be operated by the branch of a foreign market operator, the supervision of the regulated market would clearly fall under the branch Member State. This situation would call for close co-operation between the supervisors of the home state of the market operator, responsible for supervising the latter, and the branch state, responsible for market regulation and supervision, as the latter would be considered the home state of the regulated market.

Second, even the situation in which the market operator is only active under provision of services by seeking for cross-border remote access to the regulated market(s) it operates, will lead to shared supervision by home and host state. Article 56 (2) applies some form of 'economic substance test' in deciding who should supervise the operation of the regulated market which has set up 'arrangements' in another Member State: when the importance of these operations in the host state, taking into account the situation of its securities markets, has become of substantial importance for the functioning of the securities markets and the protection of the investors in that state, the home and host country supervisors will establish 'proportionate cooperation arrangements'. This seems to point to a joint responsibility for supervision, although the directive is not very clear on the issue. The economic substance test has to be assessed taking into account the relative situation of the remote regulated market, compared to the domestic hostcountry securities markets, and not in relation to the relative size of the market operations in the home and host country. It is clear that, in the present stage of market integration, Member States apparently are not yet willing to lose control over the supervision of locally active securities markets.

The possibilities for cross-border activity of a *Multilateral Trading Facility* (MTF) under MiFID have been modelled on the principles applicable to regulated markets, to such an extent as to create a high degree of competitive equality amongst both categories of trading venues. The operational structure of an MTF is, however, somewhat different: while a regulated market will by definition be managed or operated by a 'market operator', MiFID provides for two possibilities in respect of MTF's: the MTF can be operated by a 'market operator', that by definition also manages or operates a regulated market.[25] Alternatively, the operation of an

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[24] See also CESR 'Preliminary Progress Report: Which supervisory tools for the EU securities markets?' (October 2004) <http://www.cesr-eu.org>.

[25] See the definition of 'market operator' in Article 4 (13) MiFID.

MTF may be entrusted to an investment firm.[26] To that end, the list of investment services in the annex to MiFID has been extended so as to include the operation of MTF's into the list of core investment services.[27] The latter situation offers facilities for cross-border expansion in the operation of MTF's that do not exist under the regime of regulated markets. To the extent that an MTF is operated by an investment firm, the latter will enjoy the full benefits of the European passport: it will be able to operate an out-of state-MTF through direct provision of services from another Member State or by setting up a branch office. Likewise, an investment firm will be able to use its European passport to allow clients situated in other Member States to execute transactions on its home state operated MTF, and to grant remote access to the MTF to financial institutions established in other Member States. Like for regulated markets, MiFID obliges Member States to provide appropriate arrangements so as to facilitate the access to and the use of their systems by remote users or participants.[28]

As far as supervision of the operator of an MTF is concerned, the supervisory regime will follow the home country control paradigm when the operator is an investment firm, as the cross-border expansion of the business as operator of an MTF is covered by the European passport. Similarly, the 'market operator', when providing 'appropriate arrangements' for remote access to an MTF in other Member States, will be subject to supervision in its state of origin. Contrary to the situation of regulated markets, where some joint responsibility for supervising the market operation follows from Article 56 (2) MiFID, the directive does not refer to a 'substance' test in deciding to allocate supervisory powers between home and host state, when an MTF is accessible in different Member States through 'appropriate arrangements'. Irrespective of the general obligation for the supervisory authorities to co-operate and to offer mutual assistance[29], the supervision of the operating conditions of an MTF will be of the competence of the home state of the market operator.

Transactional Regulation: Conduct of Business Rules

One of the areas in which MiFID has made substantial progress in attaining regulatory convergence amongst Member States, is the area of conduct of business. The adoption of detailed level 2 rules will result in real European rulebooks for investment activities.[30] Beside the convergence in substance, the shift to home country control as regards cross border provision of services is an important step forward in making the single passport a powerful tool for truly integrated markets.

At the same time, MiFID has not clearly resolved the discussions that existed under the ISD regime as to the legal nature of the conduct of business rules and their enforceability in contract or in tort by investors.[31] In the present situation, no uniform picture emerges from the situation in the different Member States: in the absence of clear provisions in the laws of most Member States as to the actionability in court of conduct of business rules, the prevailing opinion in a minority of Member States holds that conduct of business rules are of a purely supervisory nature and cannot, therefore, be relied upon in court by an investor (e.g. Germany). In most Member States, however, the opposite opinion would prevail, even though case law seems to be rare, if not inexistent.[32] The 'objectives' to be attained through conduct of business rules, as Article 11 ISD had phrased it, have been replaced by 'high level principles' in Article 20 MiFID, which altogether attain a substantially higher degree of precision. The main innovation compared to ISD lies in the circumstance that the further refinement of the 'principles' is no longer left to the Member States, but to the Commission through a level 2 mandate. It still remains unclear, however, to which extent the conduct of business rules should be considered as mere supervisory rules, or whether they will also be actionable in court by investors. It goes without saying that the conduct of business rules have at least a supervisory nature. This appears clearly from Article 17 (1), according to which Member States should ensure that their competent authorities monitor the activities of investment firms, so as to assess compliance with the operating conditions (including conduct of business rules) provided for in

[26] Article 4 (15) MiFID, that refers to both possibilities in the definition of a MTF.

[27] See Annex I, A, (8) MiFID.

[28] Article 31 (5) MiFID.

[29] See Article 56 (1) MiFID.

[30] See the proposal for a directive cited *supra*, note 10. This leaves aside the question whether integration through law is likely to produce the most optimal results. See for a critical approach: N Moloney 'Building a Retail Investment Culture through Law: The 2004 Markets in Financial Instruments Directive' (2005) 6 Eur Bus Org L Rev 341-422.

[31] See, on this issue, M Tison 'Conduct of Business Rules and their Implementation in the EU Member States' in G Ferrarini, KJ Hopt and E Wymeersch (eds) *Capital Markets in the Age of the Euro* (Kluwer Law International 2002) 65, 78-80.

[32] See, for instance, the situation in Belgium, where the same scholarly debate took place when implementing Article 11 ISD into the Belgian Law of 6 April 1995. It should be noted that Belgian courts have in recent years been surprisingly cautious in holding investment firms liable on the basis of the conduct of business rules. In most cases, liability was founded on general rules of contract law (duty of diligence in contract, ...) instead of referring to the (often more detailed) conduct of business rules. This may indicate that the detailed conduct of business rules can, at least in part, be construed through interpretation of the general standards of contractual duties or tort liability.

MiFID. This does not in itself exclude a possible private enforceability of the conduct of business rules. The underlying general objectives of MiFID plead in favour of private enforceability: even stronger than under ISD, the preamble to MiFID stresses investor protection as a primary objective of the directive.[33] Likewise, the conduct of business rules (and related client handling rules) are part of the section entitled 'Provisions to ensure investor protection'. Although this does not provide a conclusive argument, as investor protection could also be promoted through supervisory rules, an analysis of the substance of the 'high level principles' shows that preciseobligations are imposed on investment firms towards investors (e.g. keeping of records of rights and duties of parties, obligation to hand over reports to the investor, ...). In conclusion, it seems fair to assert that the conduct of business rules, even more strongly than under ISD, are likely to be relied upon by investors against investment firms, and will create legally enforceable rights.

Finally, it should be noted that MiFID has split up the supervisory competence between cross-border provision of services and branch establishment, by allocating regulatory and supervisory competence for the latter to the host country. By shifting to home country control for cross-border services, a major criticism against the compatibility of Article 11 ISD with the EC Treaty has been wiped away. However, it remains to be seen to which extent the automatic submission of branches to the host state conduct of business rules will resist scrutiny with Article 43 EC on freedom of establishment. The ECJ's decision of 5 October 2004 in the *Caixa-Bank France* case,[34] may cast some doubts in this respect. In this case, the French subsidiary of Caixa-Bank had taken up a deposit-taking activity in France through the offer of interest bearing sight accounts, which contravened French regulations. After being ordered to halt the offer of these accounts by the Banque de France, Caixa-Bank challenged this decision in court, which referred the case to the ECJ. The Court decided that the prohibition under French law to offer interest bearing accounts did constitute a restriction to freedom of establishment for Caixa-Bank, as it deprived the latter of an important means of gaining market access in the French market, taking into account in particular the competitive advantage that local banks with an extensive network of branches enjoyed. The Court considered that the general good could not justify the restriction.

The judgment in *Caixa-Bank France* is important, as the ECJ for the first time examined the compatibility of rules on financial products, which relate to the exercise of an economic activity, with the freedom of establishment. The Court acknowledges that such rules could in some circumstances restrict effective market access through an establishment. It remains to be seen whether or not this case will provoke a plethora of new cases, where host state rules governing the exercise of an economic activity will be challenged under the Treaty provisions on freedom of establishment. The argument could be transposed as well to conduct of business rules under MiFID: if a disparity of conduct of business rules between home and host state could result in restricting an effective access to the host state market by the branch of a foreign investment firm, this may amount to a prohibited restriction to the freedom of establishment. The allocation of powers to the branch state under MiFID should therefore continue to be interpreted in line with the Treaty freedoms, which could limit the actual exercise of this competence.

We further submit that even *Caixa-Bank* will not fully put host state conduct of business rules under pressure in the name of freedom of establishment: in *Caixa-Bank*, the ECJ concluded to the existence of a restriction to freedom of establishment only after having pointed at the cardinal importance for the foreign competitor to use the remuneration of bank deposits as an effective tool to penetrate the market. Implicitly, the Court applied a 'contestable market' approach in identifying the restriction to market access: foreign competitors should be granted the necessary means to effectively enter into competition with locally established financial institutions.[35] It is doubtful whether the conduct of business rules can play the same pivotal role in allowing foreign competitors to challenge host state established enterprises as was the case in *Caixa-Bank France*. First, the conduct of business rules do not, in general, shape the essential characteristics of a financial service, but mostly impair on the conditions under which a financial product will be offered (information as to the products offered, disclosure of conflicts of interest, disclosure of client handling rules, inquiry as to the situation of customers – KYC, …). Disparities in these conduct of business rules will only exceptionally be such as to form an essential element in realising effective market penetration for a new market entrant. Furthermore, the nature of the financial products will in many cases enable to 'exploit' a competitive disadvantage between foreign investment firms that do not have an extensive branch network, and firmly established local competitors in the host Member States, as was the case in *Caixa-Bank France*. Although, for some investment services, the proximity between the supplier and the client may provide a competitive advantage to the locally established firms (e.g. private

[33] This situation contrasts with the sectorial directives of the 1992 Internal Market Programme, for which the ECJ held in Case C-222/02 *Peter Paul and others* (n 12) that the protection of depositors only constituted a side-effect of the primary aim of the directives, i.e. achieving market integration.

[34] Case C-442/02 *CaixaBank France v Ministère de l'Économie, des Finances et de l'Industrie*, judgment of 5 October 2004, not yet reported in ECR.

[35] According to Spaventa, however, the Court failed to clearly delimit the concept of market access in *Caixa-Bank*, thus potentially allowing the scrutiny of any measure regulating economic life (E Spaventa 'Note under Case C-442/02 *Caixa-Bank France*' (2005) 42 Comm Mkt L Rev 1151, 1156.

banking activities), this will not be so for many other investment services (e.g. execution-only services). For the latter, it will be largely indifferent whether or not the supplier has a wide-spread branch network, as other means of communication can act as a suitable substitute (e.g. on line trading). In conclusion, it may well be that the ECJ's move in *Caixa-Bank France* will remain exceptional, and does not threaten the allocation of regulatory and supervisory competence with respect to conduct of business rules to the host state.

The Home-Host Country Division in the Prospectus Directive

Consolidation of the Home Country Rule

The elaboration of a single legal regime for prospectuses encompassing all public offers of securities, and the extension of the regime of mutual recognition of prospectus approvals make the 2004 Prospectus Directive a landmark instrument in promoting the legal framework for capital market integration. Notwithstanding the uncertainty surrounding the nature of the directive with respect to the residual powers of Member States (see above), it is clear that market participants are likely to make increasing use of the possibilities to raise capital across national borders. The detailed harmonisation of the contents and presentation of the prospectus and its ancillary documents realise a high degree of regulatory convergence in the EU. In comparison to its predecessors, the Prospectus Directive substantially extends the scope of mutual recognition, both as regards the scope of public offers caught by the directive, and with respect to the form and contents of the prospectus to be made available to investors. Finally, Article 15 of the Prospectus Directive contains general standards concerning advertisements in connection with a public offer of securities, and entrusts the home Member State with supervisory powers in this respect.

In all the abovementioned areas, the principle of mutual recognition, and the (exclusive) allocation of supervisory powers to the home state competent authority, concurrently deprives the host state to impose additional requirements or to take up supervisory competence. As regards advertisement, the Prospectus Directive thus attains a degree of convergence which is still largely absent in the other financial industry directives, where the host state generally retains residual powers in the interest of the general good.[36] The mutual recognition regime will, however, only apply for advertising made by or on behalf of the issuer or the offeror.

The issue of prospectus liability, on the contrary, has hardly been touched upon by the Prospectus Directive, and therefore remains mainly an area to be regulated in national law. Article 6 of the Prospectus Directive only contains a minimum obligation as to the indication of the persons who bear responsibility for the contents of or omissions in the prospectus, subjecting them to the normal regime of liability law. This seems at least to indicate that Member States may not allow these persons who bear responsibility to waive their liability. The directive also does not contain any indication as to the law applicable to liability claims in a cross-border offer. National conflict of laws rules will often enable aggrieved investors to sue the issuer (or other person deemed responsible) according to their local host state laws, as the place where the damage has produced its effects. From the point of view of the issuer, this risk of application of foreign liability laws will have to be taken into account in structuring the transaction, in view of the disparities existing amongst Member States as to the legal foundations of and conditions attached to prospectus liability.[37]

Derogation from Mutual Recognition: The 'Precautionary Measures' Regime

Paradoxically, the extension of the scope of mutual recognition in substance goes along with increased powers for the host Member State to set aside the mutual recognition regime in situations of threat to (host state) investors. Article 23 of the Prospectus Directive enables the host state, in the event of irregularities, to take 'precautionary measures', after prior referral of its findings to the home state authority, and where the intervention of the latter has proved unsuccessful or unsatisfactory. The directive foresees this residual competence in two situations: (1) the issuer or the financial institution in charge of the public offer have committed irregularities, or (2) the obligations attached to admission of the offered securities to a regulate market, have not been observed. The latter situation finds a reasonable explanation in the circumstance that admission to a host state's regulated market is still of the competence of that state. The residual host state power in case of 'irregularities', on the contrary, may have a more disturbing impact on the system of mutual recognition. The 'irregularities' that can enable the host state to take precautionary measures are not further specified in the directive, and could therefore result in duplication of prospectus scrutiny for multinational

[36] This if, for instance, still the case for banking and investment services – leaving aside the limited impact of conduct of business rules, and in the context of the distribution of parts of investment funds under the UCITS Directive.

[37] Compare C Sandberger 'Die EU-Prospektrichtlinie – "Europäischer Pass für Emittenten"' (2004) 7 EWS 297, 303.

issues. As Article 23 constitutes an exception to the principle of mutual recognition, which forms a cornerstone for the promotion of capital market integration, it must, in our view, receive a strict interpretation. This means first that the nature of measures to be possibly taken by the host state must be strictly necessary to safeguard investors' interests, and not may unduly impair on the cross-border capital raising activity of issuers. More importantly, the proportionality requirement does not enable the host state competent authorities to proceed to systematic scrutiny of prospectuses that have been approved by the competent home state authority. Excessive intervention by the host state can be considered contrary to the objective of the Prospectus Directive and to the EC Treaty provisions on capital movements.

Conclusions

The above general developments illustrate the conceptual ambiguities surrounding the legal patterns for capital market integration in the Lamfalussy-generation directives. Although the multi-level approach to regulation should in principle be welcomed as a powerful mechanism to promote market integration through appropriate legal instruments, new questions arise as to the (residual) powers of the Member States when implementing the Lamfalussy-style directives. The various assessment exercises made in recent years with respect to the financial integration directives have revealed that the lack of legal certainty constitutes a serious deterrent for financial services suppliers to expand their business internationally, notably in the retail segment. Although the EU regulatory framework in the 'Lamfalussy era' will result in a high degree of regulatory detail, Member States may still have an interest in maintaining more stringent rules in specific areas, for a multitude of reasons (specificities of the domestic market, regulatory tradition, …). The absence of clear identification as to the level of harmonisation does not allow for conclusiveness regarding the form of harmonisation (minimum, maximum or intermediate) presently used.

More importantly, the sequence of integration directives in various segments of the financial industry, based on different underlying concepts, amplifies the risk of internal inconsistencies. This paper has highlighted this risk *inter alia* by analysing the powers of the competent authorities to intervene in situations of deficient home state control under MiFID and the Prospectus Directive, as compared to the1992 Internal Market directives in the fields of banking and collective investment. It is clear that the dynamics of the regulatory process in market integration may not come at the price of diminished legal certainty and regulatory loopholes. The 'silent' modification of the host state residual powers to take 'precautionary measures' in some directives is likely to create confusion due to its lack of uniformity. This will be all the more inconsistent when taking into account the move to more integrated cross-border supervisory structures within the Member States, as the same supervisor will have differentiated supervisory tools at hand depending on the financial institution under supervision. It goes without saying that the credibility of the regulatory process in the markets will increase if the EU institutions manage to maintain a dynamic integration process while minimising internal inconsistencies.

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