THE UNIVERSITY *of* EDINBURGH

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OPTIMUM GOVERNANCE OF INVESTMENT CONDUCT IN THE CAPITAL MARKETS UNION

—A LEGAL AND ECONOMIC ANALYSIS

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ABSTRACT

The Action Plan on Building a Capital Markets Union ('CMU') in the European Union ('EU') was launched by the European Commission in 2015. It aims to pursue a further development and integration of European capital markets by 2019. However, in the wake of the global financial crisis of 2007–09 and the Eurozone crisis, it is proven that appropriate governance is indispensible to underpin such integrated markets. Therefore, in order to establish a solid CMU, this thesis attempts to answer one crucial question: 'whether investment conduct should be supervised centralisedly at the European level in the CMU'.

This thesis, at first, explores the regulatory system of investment conduct in the EU to date, with particular emphasis given to the competence allocation between the EU and Member States (and between Member States). Two findings are important: first, even though the rules of investment conduct are harmonised to a large extent in the EU, supervisory issues still matter to investment intermediaries and their clients in cross-border transactions; and, second, the current supervisory system of investment conduct in the EU might bring significant costs in cross-border transactions, but this does not necessarily mean that the installation of a single supervisor in charge of investment conduct supervision is inevitable in the CMU. This thesis then examines the proposed single supervisor in detail, with an aim to find out the optimum institutional governance of investment conduct in the CMU. Based on the transaction cost approach, this thesis compares the proposed single supervisor and the current system from the perspectives of private law systems and administrative regulation respectively. From the

perspective of private law governance, it is undeniable that many issues of private law in governing investment conduct are still unclear and complex in the EU, but the proposed single supervisor provides little help to these issues. By comparison, a non-mandatory pan-EU alternative dispute resolution ('ADR') for cross-border disputes of investment conduct might be a better option in reducing transaction costs in the CMU. From the perspective of administrative governance, the proposed single supervisor may also be difficult to pass the EU Treaty principles of subsidiarity and proportionality. This is because the total transaction costs of European capital markets will not decrease (but even increase) after the introduction of the proposed single supervisor. It is further argued that, other than the establishment of the proposed single supervisor, policymakers have to pay more attention on how to ensure the current network-based system functions effectively in the CMU. In the light of this, not only a negative answer of the research question is concluded, but also policy recommendations for designing the optimum governance of investment conduct in the CMU are given in this thesis.

Keywords: European Single Supervisor; Investment Conduct Regulation; Transaction Cost Approach; Capital Markets Union

LAY SUMMARY

Thanks to the right of establishment and the freedom to provide services, investment intermediaries nowadays can freely provide investment services in the European Union ('EU'). Investment intermediaries can decide to do so either on the Internet, over the phone, or through their branches or subsidiaries in other Member States. Their (potential) clients in other Member States could also enjoy a wide variety of choices. However, due to the fact that these transactions may be considered as cross-border and supranational, which competent authority is appropriate to supervise these transactions is a complicated question. Furthermore, once disputes occur, which competent authority is able to handle and resolve these disputes efficiently is also hard to be answered.

On the one hand, some may claim that investment intermediaries' behaviour should be under the centralised supervision at the EU level. On the other hand, we may still have to take into account the costs of building up such a single supervisor and the heterogeneity of capital markets between Member States. This is the debate this thesis aims to examine. This thesis explores the current regulatory system in the EU and attempts to verify the challenges of the current system, whether there is a need for the establishment of the proposed single supervisor, and whether we have other alternatives to tackle these challenges. This provides some valuable policy recommendations for establishing a true Single Market for capital in the EU—a Capital Markets Union.

DECLARATION

This is to certify that that the work contained within has been composed by me and is entirely my own work. No part of this thesis has been submitted for any other degree or professional qualification.

Signed: ____________________________

Dated: 5 June 2017

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I have learnt a lot in the process of this PhD journey–not only about my research subject, but also, most importantly, about the life. This three-year journey, which has led me to the end of this thesis, is the most crucial lesson in my life. I have been very fortunate to meet many exceptional people. Without the guidance given by them, all of this would not have been possible.

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I dedicate this thesis to my wife Fiona Ying-Chen Huang, for all of her love.

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LIST OF ABBREVIATIONS

3L3	Three Level 3 Committees (CESR, CEBS and CEIOPS)
ADR	Alternative Dispute Resolution
AIFMs	Alternative Investment Fund Managers
AIFMD	Directive 2011/61/EU on Alternative Investment Fund Managers
CASS	Client Assets Sourcebook
CCPs	Central Counterparties
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
COBS	Conduct of Business Sourcebook
CMU	Capital Markets Union
CRAs	Credit Rating Agencies
DG COM	Competition Directorate General
DG MARKT	Internal Market and Services Directorate General
DMD	Directive 2002/65/EC concerning Distance Marketing of Financial Services Directive
EBA	European Banking Authority
EBU	European Banking Union
EC	European Community
ECB	European Central Bank
ECD	Directive 2000/31/EC on Electronic Commerce
ECtHR	European Court of Human Rights
CJEU	Court of Justice of the European Communities or Court of Justice of the European Union
ECN	European Competition Network
EEC	European Economic Community
EEC Treaty	Treaty establishing the European Economic Community
EFC	Economic and Financial Committee

EIB	European Investment Bank
EIOPA	European Insurance and Occupational Pensions Authority
EJN-civil	European Judicial Network in civil and commercial matters
EMIR	Regulation on OTC derivatives, central counterparties and trade repositories
EMU	European Monetary Union
ESAs	European Supervisory Authorities (EBA, EIOPA and ESMA)
ESC	European Securities Committee
ESEC	European Securities and Exchange Commission
ESFS	European System of Financial Supervision
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FCA	Financial Conduct Authority (UK regulator)
FSA	Financial Services Authority (former UK regulator)
FSAP	European Commission's Action Plan for Financial Services
FSMA	Financial Services and Markets Act
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	The International Organization of Securities Commissions
IPF	Institutional Possibilities Frontier
ISD	Investment Services Directive
ITSs	Implementing Technical Standards
KID Regulation	Regulation (EU) No 1286/2014 on key information documents for packaged retail and insurance-based investment products
KIDs	Key Information Documents
KYC	Know-Your-Client
MiFID I	Directive 2004/39/EC on Markets in Financial Instruments
MiFID II	Directive 2014/65/EU on Markets in Financial Instruments
MiFIR	Regulation (EU) No 600/2014 on Markets in Financial Instruments
MoU	Memoranda of Understanding
NCAs	National Competent Authorities

NIE	New Institutional Economics
OMC	Open Method of Co-ordination
OTC	Over-the-counter
POS	Point-of-sale
PRA	Prudential Regulation Authority (UK regulator)
PRIIPs	Packaged Retail and Insurance-based Investment Products
RTSs	Regulatory Technical Standards
SEA	Single European Act 1986
SMP	Single market programme
SSM	Single Supervisory Mechanism
TCE	Transaction Cost Economics
TEC	Treaty establishing the European Community
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
TRs	Trade Repositories
UCITS	Undertakings for Collective Investment in Transferable Securities
UCPD	Directive 2005/29/EC concerning Unfair Commercial Practices
UTCCR	Unfair Terms in Consumer Contracts Regulations 1999 (SI 1999/2083)
UCTA	Unfair Contract Terms Act 1977
UCTD	Directive 93/13/EEC on Unfair Terms in Consumer Contracts
US SEC	US Securities and Exchange Commission

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CHAPTER I

INTRODUCTION

'We are interested here in what governs institutional and systemic performance and how we may, objectively and non-presumptively, analyse and understand the variables governing performance. The underlying motivation is two fold: first, to enable us to better know what is going on in the economy and the polity; and second, to enable us to better choose and effectuate meaningful and consequential institutional changes.'[1]

1. Research Background

A single European capital market has been long dreamed by Europeanists, since the freedom of capital movement was enshrined in the Treaty of Rome (Title III, Chapter 4) in 1957.[2] The Segré report,[3] published in November, 1966 represents the first attempt to draw a comprehensive study of the problems confronting the capital markets of the European Economic Community ('EEC'). As a result of the subsequent efforts of policymakers,[4] investment intermediaries can now enjoy their freedom of providing investment services across Member States of the European Union ('EU').[5] This is the so-called 'Single Passport' regime. However, in the wake of the global

[1] Alfred Allan Schmid, *Property, Power, and Public Choice: An Inquiry Into Law and Economics* (2nd edn, Praeger, 1987), at xi.
[2] Treaty Establishing the European Economic Community, not published in official journals.
[3] Report of a Group of Experts appointed by the EEC Commission: The Development of A European Capital Market, November, 1966, available at: <http://aei.pitt.edu/31823/1/Dev_Eur_Cap_Mkt_1966.pdf> (accessed June, 2017).
[4] See further in Section 2 of CHAPTER II (pp. 17–23).
[5] Although this thesis includes many materials before the time that the European Community ('EC') dissolved into the EU in 2009, or even before the time that the European Economic Community ('EEC') renamed as the EC in 1993, the term 'EU' is used generally in this thesis, if there is no clear indication, in order to unify the usage of terms.

financial crisis of 2007–09 and the Eurozone crisis, it is proven that this 'Single Passport' is not without 'side effects'. The European Commission ('Commission') has pursued a number of initiatives to create a safer and sounder environment for the single financial market in the EU. A landmark reform is the planned creation of European Banking Union ('EBU').[6] One important policy within the EBU is the establishment of Single Supervisory Mechanism ('SSM'), which centralises prudential supervision of Eurozone banking system in the European Central Bank ('ECB').[7] Although the SSM does not, at present, have a power to supervise non-banking sectors, even if some of them are deemed to be systemically significant,[8] Article 127.6 of the Treaty on the Functioning of the European Union ('TFEU')[9] has a potential to extend it to other financial institutions except insurance companies.[10] Therefore, the establishment of SSM represents an important step towards a 'twin-peaks'[11] model in the EU, with the macro-prudential supervision centralised in the EU level and others decentralised in the national level.[12] Inspired by the success of the EBU, one on-going policy with a similar slogan is the Capital Markets Union ('CMU').[13] It was launched by Jean-Claude Juncker, the current President of the Commission, in a speech before the European Parliament

[6] For more information about the EBU, available at: <http://ec.europa.eu/finance/general-policy/banking-union/index_en.htm> (accessed June, 2017).

[7] Council Regulation (EU) No 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, 2013 OJ L287/63. ('SSM Regulation')

[8] Article 1 of SSM Regulation.

[9] Consolidated version of the Treaty on the Functioning of the European Union, 2012 OJ C 326/47.

[10] Sideek Mohamed, 'A Single Regulator for the E.C. Financial Market' (2001) 16 *Journal of International Banking Law* 203, at 209–210; Niamh Moloney, 'European Banking Union: Assessing its Risks and Resilience' (2014) 51 *Common Market Law Review* 1609, at 1659.

[11] See the definition of this term in Section 4 below (pp. 8–10).

[12] Recital 28 and Article 1 of SSM Regulation; Karel Lannoo, *ECB Banking Supervision and beyond* (CEPS Task Force Reports, 2014), at 59.

[13] Nicolas Véron, 'The Economic Consequences of Europe's Banking Union' in Danny Busch and Guido Ferrarini (eds), *European Banking Union* (Oxford University Press, 2015), paras. 2.50 and 2.67.

('Parliament') on 15 July, 2014.[14] In that speech, he said that a further development and integration of capital markets should be achieved by 2019 in order to improve the financing of Europe's economy and reduce the very high dependence on bank funding, and this would also increase the attractiveness of Europe as a place to invest.[15] The Commission then released a Green Paper on building a CMU on 18 February, 2015,[16] followed by an Action Plan on Building a CMU on 30 September, 2015.[17] According to the 'Five Presidents' Report', the launch of the CMU, alongside the EBU, is an immediate step towards the 'Financial Union' in the EU.[18]

Although relevant official documents do not explicitly mention this issue,[19] it is logical to consider the necessity of a single supervisor within the CMU since there is a SSM within the EBU.[20] Some argue that the CMU will need a centralised European

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[14] Jean-Claude Juncker, A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change, 15 July, 2014, available at: <http://ec.europa.eu/priorities/sites/beta-political/files/juncker-political-guidelines-speech_en_0.pdf> (accessed June, 2017).

[15] Ibid, at 7 and 19.

[16] European Commission, Green Paper: Building a Capital Markets Union, COM(2015) 63 final, February, 2015, available at: <http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf> (accessed June, 2017). ('Green Paper')

[17] European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Action Plan on Building a Capital Markets Union, COM(2015) 468 final, September, 2015, available at: <http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf> (accessed June, 2017). ('Action Plan')

[18] European Commission, Completing Europe's Economic and Monetary Union (reported by Juncker, J. C., Tusk, D., Dijsselbloem, J., Draghi, M., & Schulz, M.), June, 2015, at 4–5, 11–12, available at: <http://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf> (accessed June, 2017). ('Five Presidents' Report')

[19] There is one exception. The European Commission in its Communication in September, 2016 mentioned clearly that: '[t]he Five Presidents' Report highlighted the need to strengthen the supervisory framework in order to ensure the solidity of all financial actors, which should lead ultimately to a single European capital markets supervisor. The Commission will consider, in close consultation with the European Parliament and the Council, the further steps in relation to the supervisory framework that are necessary to reap the full potential of CMU.' See European Commission, Communication from the Commission: Capital Markets Union - Accelerating Reform, COM(2016) 601 final, September, 2016, at 7, available at: <http://ec.europa.eu/finance/capital-markets-union/docs/20160914-com-2016-601_en.pdf> (accessed June, 2017).

[20] Wolf-Georg Ringe, 'Capital Markets Union for Europe: A Commitment to the Single Market of 28'

supervisor,[21] but the counter-argument claims that there is no need for a more centralised supervisor due to the fact that the current institutional framework is being broadly 'fit-for-purpose' in the CMU.[22] In fact, like in the EBU, this question shall be examined by separating the two 'peaks', namely prudential supervision and conduct supervision of the CMU.[23] The former has caught some attention already,[24] while the latter still lacks proper care. Compared to a lot of stabilisation efforts have been put into the prudential supervision at the EU level, attempts to improve investor protection by the conduct supervision throughout the EU seem far less.[25] This may be because the competence allocation of the conduct supervision in the EU, whether between Member States or between Member States and the EU, are far more sensitive. For example, if an investment intermediary who is located in Member State A provides investment services to a client who is located in Member State B, who will be the most appropriate authority to supervise the investment intermediary's conduct? Does this question really matter to the investment intermediary and the client, once rules of investment conduct are the same in both Member States? If taking into account different national private law

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(2015) 9 *Law and Financial Markets Review* 5, at 7.

21 See, e.g., Robin Emimitt, 'EU Finance Chief to Announce Capital Market Plan in 2015' *Reuters* (Brussels, 6 November 2014); Jonathan Gould, 'Draghi says need single supervisor to see off risks' *Reuters* (Frankfurt, July 2, 2015).

22 See, e.g., Manon Malhère, 'Capital Markets Union: "No need for a single supervisor"' *EUROPOLITICS* (12 November 2014); Simon Lewis, 'Lord Hill should not fear ambition in pursuing capital markets union' *City AM* (3 November, 2014); Huw Jones, 'BoE paper says EU market plans don't need new supervisor' *Reuters* (London, February 27, 2015).

23 Nicolas Véron and Guntram B. Wolff, 'Capital Markets Union: A Vision for the Long Term' (2016) 2 *Journal of Financial Regulation* 130, at 21–22.

24 See, e.g., Jon Danielsson et al, *Europe's Proposed Capital Markets Union: Disruption Will Drive Investment and Innovation* (Systemic Risk Centre, LSE, 2015), at 3; Kern Alexander, 'Capital Markets Union from the Perspective of the Banking Industry and Prudential Supervision' (2015) 9 *Law and Financial Markets Review* 191, at 193–194; Viral V. Acharya and Sascha Steffen, *Capital Markets Union in Europe: Why Other Unions Must Lead the Way* (Universität StGallen WPZ Working Paper No 6, 2016), at 4–7.

25 For example, during the post-financial crisis period (namely, 2010 to 2012), only three legislative proposals were relevant to investor/consumer protection. Christian Hofmann, 'Stabilizing the Financial Sector: EU Financial Services 2010–2012' (2012) 8 *European Review of Contract Law* 426, Part C.

systems between Member States A and B, how could we reconcile these two parties' interests and the objective of the internal market in the EU? Will the CMU make a single supervisor in charge of investment conduct supervision inevitable? These important questions have to be answered in order to build a true single market for capital, and these are what this thesis seeks to explore.

2. Research Question and Objectives

This thesis attempts to answer one crucial question, i.e., 'whether investment conduct should be supervised centralisedly at the EU level in the CMU (or not)'? In order to do so, this thesis, at first, will explore the regulatory system of investment conduct in the EU to date, with particular emphasis given to the competence allocation between the EU and Member States (and between Member States). This thesis then will discuss the idea of a centralised European supervisor in charge of investment conduct supervision with an aim to find out the optimum institutional governance in the CMU. In the light of this two-step analysis, not only will the governance system of investment conduct in the EU be examined, but also policy recommendations for designing the optimum governance of investment conduct in the CMU will be given.

3. Research Methodology

The primary methodology applied by this inter-disciplinary study is an economic analysis of law, which focuses on legal, policy and transaction costs considerations. Given the aim of reducing 'costs' of European capital markets is mentioned everywhere in the Green Paper and the Action Plan of the CMU, the major arguments presented

here are deprived from the findings of the Transaction Cost Economics ('TCE'). This is not simply to impose a transaction cost analysis on a regulatory context, but to use its key notions as organising principles. Specifically, this thesis will conduct a comparative institutional analysis of the transaction costs between the current system and the option of further centralising investment conduct supervision in the EU. Only if the transaction costs associated with this option are comparatively lower than with the current system, can the centralised supervision of investment conduct be a more efficient and feasible option of the CMU. Otherwise, there may be other better choices. In fact, the transaction cost approach has been largely adopted in the study of regulation.[26] Yannis Avgerinos might be the first applying this approach to argue in favour of a single regulator of the European capital markets.[27] However, he did not distinguish the differences between prudential regulation and conduct regulation, and neither does he consider the role of private law systems in governing investment conduct. Therefore, this thesis will take both of these into account when conducting a

[26] See, e.g., Dale B. Thompson, 'Beyond Benefit-Cost Analysis: Institutional Transaction Costs and Regulation of Water Quality' (1999) 39 *Natural Resources Journal* 517, at 521–538; Antonio Estache and David Martimort, *Politics, Transaction Costs, and the Design of Regulatory Institutions* (World Bank Policy Research Working Paper No 2073, 1999), at 4–10; Laura McCann and K William Easter, 'Estimates of Public Sector Transaction Costs in NRCS Programs' (2000) 32 *Journal of Agricultural and Applied Economics* 555, at 555–564; Barak D. Richman and Christopher Boerner, 'A Transaction Cost Economizing Approach to Regulation: Understanding the NIMBY Problem and Improving Regulatory Responses' (2006) 23 *Yale Journal on Regulation* 29, at 50–65; D. Bruce Johnsen, 'The SEC's Mistaken Ban on Directed Brokerage: A Transaction Cost Analysis' (2008) 40 *Arizona State Law Journal* 1241, at 1267–1282; André Nijsen, 'SCM to Measure Compliance Costs' in André Nijsen et al (eds), *Business Regulation and Public Policy* (Springer, 2009), at 61–83; Frank den Butter, Marc De Graaf and André Nijsen, *The Transaction Costs Perspective on Costs and Benefits of Government Regulation: Extending the Standard Cost Model* (Tinbergen Institute Discussion Paper, TI 2009-013/3, 2009), at 15–22; Pablo T. Spiller, 'Regulation: A Transaction Cost Perspective' (2010) 52 *California Management Review* 147, at 147–158; Pablo T. Spiller, 'Transaction Cost Regulation' (2013) 89 *Journal of Economic Behavior & Organization* 232, at 232–242; Frank den Butter, 'The Perspective of Public Sector Economics on Regulation: Transaction Costs and the Agency Model' in Alberto Alemanno et al (eds), *Better Business Regulation in a Risk Society* (Springer, 2013), at 123–128.

[27] Yannis Avgerinos, 'The Need and the Rationale for A European Securities Regulator' in Mads Andenas and Yannis Avgerinos (eds), *Financial Markets in Europe: Towards a Single Regulator?* (Kluwer Law International, 2003), at 148–152.

transaction cost comparison. It is worth mentioning that, due to the fact that the United Kingdom ('UK') is the home Member State of many investment services providers in the EU, many research materials of this thesis are collected from the UK's practice. However, the UK triggered the official Brexit process on 29th March, 2017, which is going to change the relationship between the UK and the EU, but not so quickly.[28]

4. Definitions

Before going into further analysis, some key terms of this thesis, which have no universally agreed-upon definition, need to be clarified.

- *Regulation and Supervision*—Even there is no single agreed meaning of 'regulation', one definition is widely accepted, namely the interference/intervention of government/public agencies with the market mechanism.[29] This is 'the promulgation of an authoritative set of rules, accompanied by some [enforcing] mechanisms'.[30] It should be further emphasised that the criminal justice system is not in the sense in which the definition of 'regulation' is used here,[31] even criminal liability, in a broad sense, might have its regulatory function.[32] In short, this thesis

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[28] A letter from the British Prime Minister, Theresa May, notifying the United Kingdom's intention to leave the European Union (29th of March, 2017), available at: <http://www.consilium.europa.eu/en/press/press-releases/2017/03/pdf/070329_UK_letter_Tusk_Art50_pdf/> (accessed June, 2017).
According to Article 50 of the Treaty on European Union ('TEU'), there might be a two-year negotiation between the UK and the EU after the UK notifies the European Council its intention of leaving.

[29] Roger Bowles, *Law and the Economy* (Martin Robertson, 1982), at 164–165; Daniel Spulber, *Regulation and Markets* (The MIT Press, 1989), at 37; Tony Prosser, *Law and the Regulators* (Clarendon Press, 1997), at 5.

[30] B Robert Baldwin, Christopher Hood and Colin Scott, 'Introduction' in Robert Baldwin, Christopher Hood and Colin Scott (eds), *A Reader on Regulation* (Oxford University Press, 1998), at 3.

[31] For a similar usage of the definition of 'regulation': see Giandomenico Majone, 'The Rise of the Regulatory State in Europe' (1994) 17 *West European Politics* 77, at 81.

[32] See further in Law Commission, *A Consultation Paper: Criminal Liability in Regulatory Contexts* (Consultation Paper No 195, 2010), available at: <http://www.lawcom.gov.uk/wp-content/uploads/2015/06/cp195_Criminal_Liability_consultation.pdf

will use the term 'regulation' to refer to 'administrative regulation' only. However, this confined definition does not restrict this thesis from applying an institutional approach to analyse the complexity of institutional arrangements, rule making and practical issues that are associated with regulation.[33] Under this definition of regulation, 'supervision' is just part of regulation, except rule making.[34] 'Supervision' is further composed by four stages in implementation and enforcement, including: (i) licensing; (ii) monitoring; (iii) sanctioning; and (iv) crisis management.[35] The former two stages are *ex ante* supervision as pre-monitoring compliance systems, and the latter two stages are *ex post* supervision as post-monitoring deterrence systems.[36] It should be noted that 'supervision', *stricto sensu*, could possibly refer to the monitoring stage merely,[37] but this thesis applies a broad sense of 'supervision' as the foregoing definition.

- *Conduct Regulation and Prudential Regulation*—Albeit there can be no precise definition of these two terms. 'Conduct regulation' involves regulation of the process through which financial institutions make and perform contracts and market financial

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> (accessed June, 2017).

33 This approach is applied to establish the foundation of risk regulation regime: see Christopher Hood, Robert Baldwin and Henry Rothstein, *The Government of Risk: Understanding Risk Regulation Regimes* (Oxford University Press, 2001), at 8–9.

34 According to the definition of Black's Law Dictionary, the term 'regulation' is defined as 'the act or process of controlling by rule or restriction', and the term 'supervision' is defined as 'the act of managing, directing, or overseeing persons or projects': see Bryan A. Garner, *Black's Law Dictionary* (10th edn, Thomson West, 2014).

35 Rosa María Lastra, *Central Banking and Banking Regulation* (Financial Markets Group, London School of Economics and Political Science, 1996), at 108, 110–122; European Union Committee of House of Lords, The Future of EU Financial Regulation and Supervision, HL Paper 106-I, 17 June, 2009, para. 26, available at:
<http://www.publications.parliament.uk/pa/ld200809/ldselect/ldeucom/106/106i.pdf>
(accessed June, 2017).

36 Niamh Moloney, 'Supervision in the Wake of the Financial Crisis: Achieving Effective "Law in Action" — A Challenge for the EU' in Eddy Wymeersch, Klaus J. Hopt and Guido Ferrarini (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (Oxford University Press, 2012), paras. 4.04–4.06.

37 See, e.g., Rosa María Lastra, *Legal Foundations of International Monetary Stability* (Oxford University Press, 2006), at 87–88.

products to customers, and 'prudential regulation' focuses on the soundness and solvency of financial institutions.[38] Within the institutional structure of the so-called 'twin-peaks' model,[39] conduct regulation (which was developed in the securities sector only for the objective of investor protection) is normally separated from prudential regulation (which was initially targeted at banks and life insurers for financial stability).[40] There are good reasons for separating them: (i) the focus of former is micro, while that of later is macro; (ii) the former pays more attention on small participants, while main, large players and the whole market take the centre stage of the later; and (iii) the former can be achieved by taking individual measures, while consensual agreements is normally needed for the later.[41] This separation is an 'objective-based' regulation,[42] with a major advantage that regulators can focus on their own targets along with the suitable allocation of supervisory responsibilities.[43] However, due to the imprecise definitions, there is a considerable

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[38] Gerard McMeel and John Virgo, *McMeel and Virgo on Financial Advice and Financial Products* (3rd edn, Oxford University Press, 2014), paras. 1.61–1.63. Although this topic is out of the scope of this thesis, prudential regulation could further be viewed from either a 'macro' or a 'micro' perspective. The objective of a former is to limit the risk of financial distress with significant losses to the economy as a whole, while the latter is to limit the risk of financial distress at individual institutions, regardless of their impact on the overall economy. Likewise, the macro-prudential perspective assumes that risk is in part endogenous with respect to the behaviour of the financial system, but the micro-prudential approach assumes that it is exogenous. For a comprehensive discussion of this divide: see Claudio Borio, *Towards a Macroprudential Framework for Financial Supervision and Regulation?* (BIS Working Papers No 128, 2003).

[39] The term of 'twin-peaks' was first used by Taylor: see M. Taylor, *"Twin Peaks": A Regulatory Structure for the New Century* (Centre for the Study of Financial Innovation, 1995).

[40] G. McMeel and J. Virgo, above note 38, paras. 1.61–1.63.

[41] Charles AE Goodhart, 'Some Regulatory Concerns' (1996) 132 *Swiss Journal of Economics and Statistics* 613, at 615–616.

[42] Four general approaches of financial regulation have been discussed and adopted in different countries: (i) institution-based; (ii) function-based; (iii) objective-based; and (iv) integrated approach. Giorgio Di Giorgio and Carmine Di Noia, 'Financial Supervisiors: Alternative Models' in Donato Masciandaro and Marc Quintyn (eds), *Designing Financial Supervision Institutions: Independence, Accountability and Governance* (Edward Elgar, 2007), at 346–354; see also G30, *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace* (Working Group on Financial Supervision, 2008), at 23–24. See further in Section 3.1 of CHAPTER III (pp. 86–88).

[43] Jr. Henry M. Paulson, Robert K. Steel and David G. Nason, *Blueprint for A Modernized Financial Regulatory Structure* (The Department of The Treasury, 2008), at 142.

overlap between these two 'peaks'.[44] For example, internal control mechanisms (such as, conflict-of-interest needs of intermediaries to structure and organise a way of providing services) may not be simply classified as either prudential regulation or conduct regulation.[45]

- *Investment Conduct Regulation*—Given the aforementioned definition of 'regulation' and 'conduct regulation', 'investment conduct regulation' is defined here as the intervention of public agencies on 'the way investment intermediaries provide investment advice, asset management, and trade matching and execution services to their clients, as well as the way they conduct investment promotions'.[46] It is also called conduct-of-business regulation[47], or best practice regulation,[48] with an aim to safeguard the behaviour's honesty, fairness, loyalty and confidentiality of investment intermediaries.[49] Having said that, investment conduct regulation is just part of conduct regulation in capital markets,[50] but most efforts of this thesis will

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44 Clive Briault, *The Rationale for a Single National Financial Services Regulator* (FSA Occasional Paper Series No 2, 1999), at 24.
45 Michel Tison, 'Conduct of Business Rules and Their Implementation in the EU Member States' in Guido Ferrarini, Klaus J. Hopt and Eddy Wymeersch (eds), *Capital Markets in the Age of the Euro: Cross-Border Transactions, Listed Companies and Regulation* (Kluwer Law International, 2002), at 72–73. See further in Section 3.3.5 of CHAPTER II (pp. 43–48) and Section 2.2 of CHAPTER III (pp. 80–85).
46 Emilios Avgouleas, 'Reforming Investor Protection Regulation: The Impact of Cognitive Biases' in A. I. Ogus, Michael Faure and Frank H. Stephen (eds), *Essays in the Law and Economics of Regulation: In Honour of Anthony Ogus* (Intersentia, 2008), at 146.
47 Tarjei Thorkildsen, 'Conduct of Business Rules: What We Have and What We can Expect' (1995) 16 *Company Lawyer* 300, at 300.
48 Stefan Grundmann and Falko Glasow, *European Company Law: Organization, Finance and Capital Markets* (2nd edn, Intersentia, 2012), at 529–530.
49 Emilios Avgouleas, 'The Harmonisation of Rules of Conduct in EU Financial Markets: Economic Analysis, Subsidiarity and Investor Protection' (2000) 6 *European Law Journal* 72, at 74.
50 In the EU law, conduct regulation in capital markets has three focuses: (i) investment intermediaries providing investment services and activities shall subject to 'adequate organisational requirements in the area of internal control functions'; (ii) investment intermediaries providing investment services and activities have to follow 'appropriate conduct of business rules'; and (iii) market abuse in the form of 'insider dealing and market manipulation' must be prevented. See Articles 47(c)–(e) of Regulation (EU) No 600/2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, 2014 OJ L173/84. ('MiFIR')

be spent on investment conduct regulation. Specifically, investment conduct regulation encompasses five parts: (i) mandatory information disclosure; (ii) the honest and integrity of investment intermediaries; (iii) fair business practice and marketing; (iv) objective and high-quality advice; and (v) investment intermediaries' duty of care.[51] Likewise, avoiding conflicts of interest could be seen as the sixth part of investment conduct regulation.[52]

5. Thesis Outline

In dealing with the aforementioned research question, the remaining part of this thesis is divided in six chapters. It starts with an examination with regard to the competence allocation of rule-making system and of the supervisory system in the EU separately. *Chapter II: Competence Allocation of Investment Conduct Regulation in the EU—Rules and Rule-Making System* explores the Treaty bases, the multi-level rule-making system, and the harmonised rules of investment conduct in the EU. Due to the fact that regulatory competition and the home country control may not be able to function in an orderly way, harmonisation of rules is necessary for European capital markets. This exploration also reveals institutional tension within the current system and highlights the limited function of the 'Single Rulebook', as well as the ignored role of private law systems. In fact, as mentioned by the Action Plan of CMU, the limited function of the Single Rulebook may be tackled by greater supervisory convergence, while the issue of

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[51] David T. Llewellyn, *The Economic Rationale for Financial Regulation* (FSA occasional paper, 1999), at 11–12.

[52] Guido Ferrarini, 'Contract Standards and the Markets in Financial Instruments Directive (MiFID): An Assessment of the Lamfalussy Regulatory Architecture' (2005) 1 *European Review of Contract Law* 19, at 33–35; S. Grundmann and F. Glasow, above note 48, at 538–540.

private law systems in governing investment conduct may not be so easy to be resolved due to the limitations set in the Treaty on European Union ('TEU') and TFEU.

Chapter III: Competence Allocation of Investment Conduct Regulation in the EU—Supervisory System analyses interactions between European agencies and national authorities, as well as between national authorities of home and host Member States. Conflicts between these relationships in cross-border transactions of investment services are significant. On the one hand, European agencies encounter some constitutional constraints, and, on the other hand, due to the divergent supervisory 'cultures', abilities of national authorities to uniformly apply harmonised rules are also restricted. Given the successful precedent of building the SSM within the EBU, this situation may call, at least implicitly, for establishing a single supervisor in charge of investment conduct supervision in the CMU. However, we should not blindly believe this is an absolute answer. In other words, what we have to ask is: whether this proposed reform could really bring a better outcome than the current system?

Before answering this question, it is necessary to build consolidated theoretical foundations for the institutional comparison. *Chapter IV: Transaction Cost Approach of Investment Conduct Governance* reviews the extensive literature on the transaction cost approach. First, the transaction cost approach provides a single criterion to analyse different types of investment conduct governance, which includes administrative regulation and private law systems. Second, from a normative perspective, the optimum governance (i.e., one form of governance could reduce transaction costs to the minimum) of investment conduct could be found by an institutional comparison, and it

possibly will be a hybrid of administrative regulation and private law systems here. Third, from a positive perspective, it is only if transaction costs could comparatively decrease after the introduction of reforms, otherwise, the reforms will not be possible and feasible in practice.

In the light of the transaction cost approach, the research question shall be answered by a two-fold institutional comparison of investment conduct governance in the EU: one is private law governance, and another is administrative governance. On the basis of a comprehensive analysis of the European private law and of the UK's practice, *Chapter V: Optimum Private Law Governance of Investment Conduct in the Capital Markets Union* points out many challenges (such as, a multiplicity of jurisdictions and large variations of national private laws across Member States) faced by the current private law governance of investment conduct in the EU. All of these problems will not be resolved by establishing a single supervisor, which means transaction costs will not be decreased by this reform. Therefore, in view of the institutional comparison of the private law governance, there may be no argument in favour of the further centralisation of investment conduct supervision for reducing transaction costs in the CMU. By comparison, a non-mandatory pan-EU alternative dispute resolution ('ADR') for cross-border disputes of investment conduct might be a more feasible option to tackle these problems instead, followed by an enhancement of investors confidence in buying cross-border investment services in the EU.

In accordance with the TEU and TFEU, *Chapter VI: Optimum Administrative Governance of Investment Conduct in the Capital Markets Union* conducts an institutional

comparison of administrative governance between the current system and the centralised investment conduct supervision in the EU. Two findings are significant. First of all, centralisation is not the sole solution for tackling cross-border issues of investment conduct supervision, so it might be hard to pass the 'cannot be sufficiently achieved' test within the principle of subsidiarity of Article 5.3 of the TEU. Second, the results of this thesis's institutional comparison indicate that the total transaction costs of European capital markets will not decline (but even rise) after the further centralisation of investment conduct supervision in the EU. This reform, thus, is also hard to pass the 'better achieved' and 'necessary to achieve' tests within the principles of subsidiarity and proportionality of the TEU (Articles 5.3 and 5.4). According to this, the argument in favour of the centralised investment conduct supervision for reducing transaction costs of European capital markets may not be held from the viewpoint of administrative governance either.

Finally, *Chapter VII: Conclusion* seeks to bring together a coherent conclusion. It concludes with a negative answer of the research question based on the institutional comparison made by this thesis. Also, it reveals a 'too much focus' on administrative governance in the EU. Private law governance, by contrast, is touched far less by European policymakers. In order to build the optimum governance of investment conduct in the CMU, any forthcoming policy has to secure an optimal interplay between administrative regulation and private law systems. A more comprehensive viewpoint of European capital markets law is needed in the on-going 'Europeanisation' trend.

CHAPTER II

COMPETENCE ALLOCATION OF INVESTMENT CONDUCT REGULATION IN THE EU—RULES AND RULE-MAKING SYSTEM

'Economists distinguish between "trade creation" and "trade diversion" in a customs union. Trade creation represents a shift to a more efficient producer as a result of the establishment of the customs union, while the opposite is true of trade diversion. By analogy, we can say that, in the field of regulatory policy-making, European integration has meant "rule creation"—new and generally better rules both at the national and supranational levels—rather than simply "rule diversion" from one level of government to another.'[1]

1. Introduction

Generally, there are three focuses of the rules of investment conduct in the world, depending on the extent of intervention from regulatory authorities: first, the 'arm's length project', with the least intervention from authorities, aims to protect the consent of risk takers be informed; second, the 'fiduciary project' puts more requirements on financial intermediaries to maintain their clients' trust; and third, the 'consumerist project' pays more attention on the fairness, so the weaker parties should be protected more.[2] Given these common focuses, rules of investment conduct were harmonised internationally by the International Organization of Securities Commissions ('IOSCO')

[1] Giandomenico Majone, *Regulating Europe* (Routledge, 1996), at 59.
[2] Joanna Benjamin, *Financial Law* (Oxford University Press, 2007), Chs. 25–27.

in 1990.[3] However, how does this harmonisation further happen in the EU?[4] In particular, since there are twenty-eight Member States within the EU, how do they reach a balanced and efficient consensus within the complex legislative procedure? The answers to these questions closely link up with the competence allocation of the rule-making powers in relation to investment conduct regulation in the EU. This is what this chapter will examine. In order to highlight the complexities and challenges of the current rule-making system in the EU, Treaty bases, case law of the Court of Justice of the European Union ('CJEU'),[5] rule-making process and harmonised rules of investment conduct will all be explored comprehensively in this chapter. This exploration is crucially important for the evaluation of the optimum governance of investment conduct in the EU, due to the fact that investment conduct regulation falls into a comparatively sensitive area of the EU/Member States relationship.

This chapter falls into four sections. Section 2 discusses the internal market of investment intermediaries in the EU and points out a necessity for harmonisation on the basis of the EU Treaties.[6] Section 3 explores a multi-level rule-making system that is tasked with the role of harmonisation in the EU by an efficient way. Thanks to this rule-making system, rules of investment conduct are harmonised in the EU to a large

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[3] See International Organization of Securities Commissions ('IOSCO'), International Conduct of Business Principles, July, 1990, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD8.pdf> (accessed June, 2017).

[4] For the US experience and other international comparisons of investment conduct regulation: see Andrew F. Tuch, 'Conduct of Business Regulation' in Niamh Moloney, Eilís Ferran and Jennifer Payne (eds), *The Oxford Handbook on Financial Regulation* (Oxford University Press, 2015), at Parts III–V.

[5] This thesis uses the term 'CJEU' to refer to either the Court of Justice of the European Communities or Court of Justice of the European Union generally, depending on the time of case law. The role of the CJEU is to ensure the interpretation and application of the Treaty on European Union ('TEU') and the Treaty on the Functioning of the European Union ('TFEU'). See the consolidated versions of the TEU, 2012 OJ C 326/13, Article 19.

[6] The term 'EU Treaties' is deployed here to refer to the TEU and the TFEU.

extent, which are also analysed in detail in this section. Section 4 further examines relevant challenges faced by the current system and policy implications aiming at tackling these challenges. Section 5 brings the discussion of this chapter to conclusion.

2. Internal Market and Single Passport of Investment Intermediaries in the EU

2.1. Right of Establishment and Freedom to Provide Services

When providing (or marketing) investment services in the European internal market, it would principally relate to the right of establishment and the freedom to provide services. First, in relation to the right of establishment, Articles 49 and 54 of the TFEU contemplate both a 'primary' and a 'secondary establishment':

> 'with a primary establishment, an individual leaves State A to set up a permanent establishment in State B; with a secondary establishment, an individual maintains an establishment in State A while setting up a second professional base (e.g., offices, chambers, agencies, branches or subsidiaries) in State B.'[7]

These Articles expressly leave people a freedom to choose appropriate forms to pursue their activities.[8]

Second, with regard to the freedom of service provision, Articles 56 and 57 of the TFEU lay down the freedom to provide services by a natural person (or legal person)[9]

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[7] Catherine Barnard, *The Substantive Law of the EU: the Four Freedoms* (4th edn, Oxford University Press, 2013), at 307.

[8] CJEU, Case 270/83, *Commission v France (tax credits)*, [1986] ECR 273, para. 22.

[9] Article 54 of the TFEU regarding 'companies or firms' is also applied to the freedom to provide services: see Article 62 of the TFEU.

established in one Member State to a recipient established in another Member State, and any restriction on this freedom shall be prohibited. However, compared to the right of establishment—which is a permanent right on 'a stable and continuous basis'[10] involving 'the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period'[11]—the freedom to provide services is permitted on 'a temporary basis'[12], and it only applies if the right of establishment does not apply.[13] As to the temporary nature of the activities in question, it has to be 'determined in light, not only of the duration of the provision of the service, but also of its regularity, periodicity or continuity'.[14] In addition, since the free movement of capital is 'a precondition for the effective exercise of other freedoms' (in particular, the right of establishment),[15] there may be a potential overlap here between Article 63 that abolishes any restriction on the movement of capital and the two freedoms aforementioned (namely, the right of establishment and the freedom to provide services) in the EU market. This possibility, explicitly, is recognised by Articles 65.2 and 58.2 of the TFEU.

2.2. Harmonisation, Mutual Recognition and Home Country Control

As discussed in the foregoing section, providing (or marketing) investment services

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[10] CJEU, Case C-55/94, *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano*, [1995] ECR I-4165, para. 25; CJEU, Case C-70/95, *Sodemare SA, Anni Azzurri Holding SpA and Anni Azzurri Rezzato Srl v Regione Lombardia*, [1997] ECR I-03395, para. 24.

[11] CJEU, Case C-221/89, *The Queen v Secretary of State for Transport, ex parte Factortame Ltd*, [1991] ECR I-3905, para. 20.

[12] CJEU, Case C-55/94, above note 10, para. 26.

[13] Ibid, para. 22; CJEU, Case C-234/01, *Arnoud Gerritse v Finanzamt Neukölln-Nord*, [2003] ECR I-5933, para. 23. See also the sentence within Article 57.2 of the TFEU: 'temporarily pursue his activity in the Member State where the service is provided'.

[14] CJEU, Case C-55/94, above note 10, para. 27.

[15] CJEU, Case 203/80, *Criminal proceedings against Guerrino Casati*, [1981] ECR 2595, para. 8.

in the European internal market is guaranteed by the freedoms set in the EU Treaties,[16] the next question is how to eliminate extant obstacles to these freedoms? A so-called 'Single Passport/European Passport'[17] regime was formed for this, and is underpinned by three indispensible factors: (i) the legislation harmonisation set by the EU Treaties; (ii) the mutual recognition established by the case law of the CJEU; and (iii) the home country control built by the EU's legislation.[18]

Initially, the existence of a common legal framework is often viewed as a necessary precondition for the establishment and effective operation of integrated markets,[19] but it has not always been possible to enact harmonised legislation. In order to tackle this, the CJEU set a principle of mutual recognition for facilitating the integration of the internal market in the leading case of *Cassis de Dijo*,[20] and subsequent judgements[21]—whereby goods lawfully produced in one Member State would be allowed to circulate freely within the pan-EU market. This principle creates a 'new approach to harmonisation',[22] paving the way for internalising the European Market. Thanks to this principle, the freedom of movement could be ensured without the

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16 See, e.g., Articles 49, 54, 56, 57 and 63 of the TFEU.

17 European Commission, The Community Internal Market - 1993 Report, COM(94) 55 final, March, 1994, paras. 162 and 176, available at: <http://publications.europa.eu/resource/cellar/7b1c1007-88b4-4476-9742-2a1d7e0ea399.0006.01/DOC_1> (accessed June, 2017).

18 Wim Fonteyne, 'Toward a Single Financial Market' in Jörg Decressin, Wim Fonteyne and Hamid Faruqee (eds), *Integrating Europe's financial markets* (IMF, 2007), at 2.

19 Article 114 of the TFEU.

20 CJEU, Case C-120/78, *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein*, [1979] ECR 649, para. 14.

21 See CJEU, Case C-113/80, *Commission v. Ireland*, [1981] ECR 1625, para. 10; CJEU, Case C-261/81, *Rau v. De Smedt*, [1982] ECR 3961, para. 12.

22 Karen J. Alter and Sophie Meunier-Aitsahalia, 'Judicial Politics in the European Community: "European Integration and the Pathbreaking" Cassis de Dijon "Decision"' (1994) 26 *Comparative Political Studies* 535, at 537.

systematic creation of detailed rules at the EU level.[23] Thereafter, this principle was renamed as the 'home country control' of financial services in the Commission's White Paper in 1985[24] that constituted the basis of the Single European Act ('SEA') 1986.[25] The home country control, as a 'corollary' of the principle of mutual recognition, means cross-border operations of financial institutions are controlled by rules and supervisory practices of their Member States of origin.[26] On the basis of the home country control, the Investment Services Directive ('ISD'),[27] published in 1993, was the first piece of legislation allowing investment firms to conduct business across European capital markets with the sole approval of their home authorities.[28] Thus, the foundation of the Single European Passport regime was laid.

Nonetheless, the principles of mutual recognition and home country control cannot replace the role of legislation harmonisation entirely.[29] First, the principle of mutual recognition within the 1992 single market programme ('SMP')[30] raises a heated debate about the outcome of regulatory competition in the EU market.[31] The regulatory

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[23] European Commission, Communication from the Commission to the Council and the European Parliament - Mutual recognition in the context of the follow-up to the Action Plan for the Single Market, 1999 COM(1999) 299, at 3–4, June, 1999, available at: <http://ec.europa.eu/DocsRoom/documents/5884> (accessed June, 2017).

[24] EC Commission, Completing the Internal Market: White Paper from the Commission to the European Council, 1985 COM(85) 310, June, 1985, paras. 102–103, available at: <http://europa.eu/documents/comm/white_papers/pdf/com1985_0310_f_en.pdf> (accessed June, 2017).

[25] 1987 OJ L169/1.

[26] Hal S. Scott, 'International Finance: Rule Choices for Global Financial Markets' in Andrew T. Guzman and Alan O. Sykes (eds), *Research Handbook in International Economic Law* (Edward Elgar, 2007), at 379.

[27] Council Directive 93/22/EEC on investment services in the securities field, 1993 OJ L141/27. ('ISD')

[28] Article 14 of ISD.

[29] Article 53.1 of the TFEU.

[30] The 1992 SMP is the final product turned form the Commission's White Paper 1985 with the support of the SEA 1986.

[31] See, e.g., David Charny, 'Competition among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the Race to the Bottom in the European Communities' (1991) 32 *Harvard International Law Journal* 423, at 423–456; Heinz Hauser and Madeleine Hösli, 'Harmonization or Regulatory Competition in the EC (and the EEA)?' (1991) 46 *Aussenwirtschaft: Zeitschrift für internationale Wirtschaftsbeziehungen* 497, at 497–512; Norbert Reich, 'Competition between Legal Orders: A New

competition can be defined as 'a process involving the selection and de-selection of laws in a context where jurisdictions compete to attract and retain scarce economic resources'.[32] Since regulation is influenced by politics, this competition also has to deal with the interaction between the players of the political game.[33] There is no guarantee that this game will bring a 'race to the bottom' (the Delaware effect),[34] or a 'race to the top' (the California effect)[35] result. In cases of the former, the level of protection for shareholders, employees, customers and the general public has been progressively lowered in the course of this competition; while in cases of the latter, the competitive process pushes the level of regulation upwards.[36] Due to this unpredictability, the range of regulatory competition should be limited by harmonisation to some extent: 'the applicable Community legislation sets a floor, the Treaty itself sets a ceiling and the Member States are free to pursue an independent domestic policy between these two parameters'.[37] This is the so-called 'reflexive harmonisation',[38] which considers the

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Paradigm of EC law?' (1992) 29 *Common Market Law Review* 861, at 861–896; Simon Deakin, 'Two Types of Regulatory Competition: Competitive Federalism vesus Reflexive Harmonisation. A Law and Economics Perspective on Centros' (1992) 2 *Cambridge Yearbook of European Legal Studies* 231, at 231–260; Jeanne-Mey Sun and Jacques Pelkmans, 'Regulatory Competition in the Single Market' (1995) 33 *Journal of Common Market Studies* 67, at 67–89.

32 Catherine Barnard and Simon Deakin, 'Market Access and Regulatory Competition' in Catherine Barnard and Joanne Scott (eds), *The Law of the Single European Market: Unpacking the Premises* (Hart Publishing, 2002), at 198; Simon Deakin, 'Is Regulatory Competition the Future for European Integration?' (2006) 13 *Swedish Economic Policy Review* 71, at 74.

33 Dale D. Murphy, *The Structure of Regulatory Competition: Corporations and Public Policies in a Global Economy* (Oxford University Press, 2006), at 254.

34 William L. Cary, 'Federalism and Corporate Law: Reflections upon Delaware' (1974) 83 *The Yale Law Journal* 663, at 705.

35 David Vogel, *Trading Up: Consumer and Environmental Regulation in a Global Economy* (Harvard University Press, 1997), at 5–6.

36 See further in Section 4.2 of CHAPTER VI (pp. 285–291).

37 Michael Dougan, 'Minimum Harmonization and the Internal Market' (2000) 37 *Common Market Law Review* 853, at 855.

38 Simon Deakin, 'Regulatory Competition versus Harmonization in European Company Law' in Daniel C. Esty and Damien Geradin (eds), *Regulatory Competition and Economic Integration* (Oxford University Press, 2001), at 209–213; Simon Deakin, 'Legal Diversity and Regulatory Competition: Which Model for Europe?' (2006) 12 *European Law Journal* 440, at 444–445; S. Deakin, 'Is Regulatory Competition the Future for European Integration?', above note 32, at 89; Simon Deakin, 'Regulatory Competition after

measures of regulatory competition and harmonisation as complementary, rather than substitutes,[39] so they two can work together for achieving the Single Market in the EU. As Esty and Geradin conclude:

> 'regulatory systems should be set up with enough inter-jurisdictional co-operation (or harmonisation) to ensure that transboundary externalities and other market failures are addressed, but with a sufficient degree of regulatory competition to prevent the resulting governmental structure from becoming an untamed, overreaching, or inefficient Leviathan'.[40]

Second, even the right of establishment and the freedom to provide services are guaranteed by the EU Treaties,[41] these freedoms are not absolute and can be overridden by the 'public interest'/'general good'/'general interest',[42] not to mention the home country control. As the CJEU's ruling in the *Deposit Guarantee* case shows, the home country control is not a Treaty principle and can be departed from for the 'public interest'.[43] The list of the 'public interest' justifications is open-ended and wide ranging.[44] First, in relation to investment conduct regulation, the famous *Alpine* case

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Laval' (2007) 10 *Cambridge Yearbook of European Legal Studies* 581, at 609; Stelios Andreadakis, 'Regulatory Competition or Harmonisation: the Dilemma, the Alternatives and the Prospect of Reflexive Harmonisation' in Mads Andenas and Camilla Baasch Andersen (eds), *Theory and Practice of Harmonisation* (Edward Elgar Publishing, 2012), at 62–63.

[39] J.-M. Sun and J. Pelkmans, above note 31, at 88.

[40] Esty D. and Geradin D., 'Introduction' in Esty D. and Geradin D. (eds) (2001), Regulatory Competition and Economic Integration: Comparative Perspectives, Oxford University Press, at xxv.

[41] See Section 2.1 above (pp. 17–18).

[42] These terms are used interchangeably by the CJEU. For example, in the area of the freedom to provide services, 'public interest' in Case C-76/90, *Manfred Säger v Dennemeyer & Co. Ltd.*, [1991] ECR I-4221, para. 15; 'general good' in Case 279/80, *Criminal proceedings against Alfred John Webb*, [1981] ECR 3305, para. 17; 'general interest' in Case C-224/97, *Erich Ciola v Land Vorarlberg*, [1999] ECR I-2517, para. 15.

[43] CJEU, Case C-233/94, *Germany v Parliament and Council*, [1997] ECR I-2405, para. 64.

[44] CJEU, Case C-288/89, *Stichting Collectieve Antennevoorziening Gouda v Commissariaat voor de Media*, [1991] ECR I-4007, para. 14; See also C. Barnard, above note 7, Ch. 13.

indicates that 'the maintenance of the good reputation of the national financial sector'[45] and the protection of 'investor confidence in the financial markets'[46] of a Member State are eligible. Second, the imperative justifications of 'consumer protection'/investor protection is also recognised by the CJEU.[47] But, the protection of the revenue of domestic service providers,[48] or the encouragement of investment in local companies[49] are not eligible 'general good' objectives. Given the above exceptions of the home country principle, it is proven again that the aim of market integration cannot be achieved in the absence of harmonised legislation.[50]

3. Harmonisation of Investment Conduct Rules in the EU

3.1. Four-Level System Established by Lamfalussy Process

In response of the indispensability of legislation harmonisation in the European internal market, the Financial Services Action Plan ('FSAP') was published in 1999[51]—it consisted of a set of harmonisation measures to be implemented by 2005 which were intended to support the integration of EU financial markets. However, European

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[45] CJEU, Case C-384/93, *Alpine Investments v Ministervan Financien*, [1995] ECR 1-1141, para. 44.
[46] Ibid, paras. 49 and 56.
[47] CJEU, Case C-222/95, *SCI Parodi v Banque de Bary*, [1997] ECR I-3899, para. 32. Technically, the ranges of 'consumer protection' and 'investor protection' are not the same, although they overlap to some extent: see further in the footnote 128 below (p. 35). In order to simplify the issue, this thesis, however, will not differentiate these two terms and use them interchangeably, if there is no clear indication. This is because 'any attempt to draw a distinction along this line [between 'investors' and 'consumers of investment services'] would be misconceived': Alan C. Page and R. B. Ferguson, *Investor Protection* (Weidenfeld and Nicolson, 1992), at 14.
[48] CJEU, Case C-288/89, *Stichting Collectieve Antennevoorziening Gouda v Commissariaat voor de Media*, [1991] ECR I-4007, para. 29.
[49] CJEU, Case C-35/98, *Verkooijen*, [2000] ECR I-4071, paras. 47 and 48.
[50] Emilios Avgouleas, 'The Harmonisation of Rules of Conduct in EU Financial Markets: Economic Analysis, Subsidiarity and Investor Protection' (2000) 6 *European Law Journal* 72, at 77–81.
[51] European Commission, Financial Services: Implementing the Framework for Financial Markets: Action Plan ('FSAP'), COM(1999)232, May, 1999, available at: <http://ec.europa.eu/internal_market/finances/docs/actionplan/index/action_en.pdf> (accessed June, 2017).

legislative processes[52] might be too slow, too rigid, producing too much ambiguity and failing to distinguish between core principles and detail to do so.[53] In order to tackle this problem, the so-called Lamfalussy report proposed a four-level system to allocate the competence of rule making in the EU—namely, the 'Lamfalussy process'.[54] This multi-level system also reflects an administrative paradigm with three characteristics in rule making: first, rules 'should be defined through the application of administrative expertise'; second, rules 'should be defined through a broadly participative process'; and third, rules 'should be subject to a cost-benefit analysis'.[55] Before starting a further analysis, it should be noted here that the Lamfalussy process is based on the Treaty establishing the European Community ('TEC'),[56] because, during that period, the Treaty of Lisbon[57] had not yet been signed.

At Level 1 of the Lamfalussy process, the framework legislation is proposed by the Commission and adopted by the Council of the European Union ('Council') and the European Parliament under the ordinary legislative procedure.[58] In order to achieve the principles of the framework legislation, more detailed implementing measures are prepared by the Commission at Level 2 of the Lamfalussy process to supplement Level 1 framework legislation.[59] The European Securities Committee ('ESC'), also called the

[52] For the ordinary legislative procedure of the EU currently: see Article 294 of the TFEU.
[53] European Commission, Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, February, 2001, at 14–15, available at: <http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf> (accessed June, 2017). ('Lamfalussy report')
[54] Ibid, at 6.
[55] James J. Park, 'The Competing Paradigms of Securities Regulation' (2007) 57 *Duke Law Journal* 625, at 663.
[56] Consolidated version of the Treaty establishing the European Community, 2002 OJ C 325/33. ('TEC')
[57] Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, 2007 OJ C 306/1.
[58] Article 251 of the TEC. See further in Lamfalussy report, above note 53, at 22–27.
[59] Article 202 of the TEC, and Council Decision 99/468/EC laying down the procedures for the exercise

Level 2 Committee, was set up to assist the Commission in implementing measures and to provide advice on policy issues in the securities field.[60] However, the procedure for Level 2, which excludes the Parliament's involvement, caused strong political resistance, so 'sunset clauses' had to be imposed in Level 1's legislation to protect the Parliament's participation of the rule-making process.[61] As to Level 3 of the Lamfalussy process, three network-based committee' forums that co-ordinate national authorities were built, facilitating convergent regulatory practice consistently.[62] These three forums include the Committee of European Securities Regulators ('CESR'),[63] the Committee of European Banking Supervisors ('CEBS')[64] and the Committee of European Insurance and Occupational Pensions Supervisors ('CEIOPS').[65] CESR was the committee in charge of the securities field, having advisory powers and could only issue non-binding

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of implementing powers conferred on the Commission, 1999 OJ L184/23. See further in Lamfalussy report, above note 53, at 28–36.

60 Commission Decision 2001/528/EC establishing the European Securities Committee, 2001 OJ L191/45. For historical reasons, the terms 'securities', 'securities law' and 'securities regulation' are generally employed in the USA, and in the early years of the EU, but, recently, 'capital markets law' and 'capital markets regulation', less specifically delineated and more broadly understood terms, are applied by the EU law to supplant the ambit of 'securities'. In order to prevent confusion, these two types of terms are used interchangeably and shall mean the same in this thesis. See further explanation about these terms: see Cally Jordan, *International Capital Markets: Law and Institutions* (Oxord University Press, 2014), footnote 7 of page 7; Georgina Tsagas, 'The Regulatory Powers of the European Supervisory Authorities: Constitutional, Political and Functional Considerations' in Mads Andenas and Gudula Deipenbrock (eds), *Regulating and Supervising European Financial Markets: More Risks than Achievements* (Springer, 2016), footnote 4 of page 15.

61 Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press, 2014), at 869–872. For example, Directive 2004/39/EC on markets in financial instruments imposes a four-year period as a sunset clause: the Parliament and the Council have power to renew Level'2 legislation in accordance with the ordinary legislative procedure before the end this period, otherwise Level 2's legislation shall be suspended after this period: see Article 64.3 of Directive 2004/39/EC on markets in financial instruments, 2004 OJ L 145/1. ('MiFID I')

62 This is also called '3L3', which means three Level 3 Committees of the Lamfalussy process. See further in Lamfalussy report, above note 53, at 37–39.

63 Commission Decision 2001/527/EC establishing the Committee of European Securities Regulators, 2001 OJ L191/43. ('CESR Decision')

64 Commission Decision 2004/10/EC establishing the European Banking Committee, 2004 OJ L3/36.

65 Commission Decision 2004/6/EC establishing the Committee of European Insurance and Occupational Pensions Supervisors, 2004 OJ L 3/30.

guidelines and recommendations.[66] Finally, Level 4 of the Lamfalussy process relates to the implementation and enforcement of enacted legislation in Member States: the Commission checks Member States' implementation and takes enforcement action for any failure to implement, or for inconsistent implementation, with the support of Level 3's committees.[67] In some cases that Member States fail to fulfil a Treaty obligation, the involvement of the CJEU might also be triggered by the Commission.[68]

Essentially, the multi-level system built by the Lamfalussy process focuses on centralised rules making instead of centralised supervision,[69] so there is no transfer of competencies from national to supranational supervision.[70] Directive 2004/39/EC on markets in financial instruments ('MiFID I')[71] is one of the most important Directives published during this period. Compared to the traditional legislation procedure, many costs of the rule-making process are comparatively reduced by this multi-level system,[72] by means of allowing 'the European institutions to benefit from the technical and supervisory expertise of European securities supervisors and from better involvement of external stakeholders'.[73]

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66 Recitals 8, 9 and Article 2 of CESR Decision.
67 See further in Lamfalussy report, above note 53, at 40–41.
68 Article 226 of the TEC; see also CESR, The Role of CESR at "Level 3" under the Lamfalussy Process, CESR/04-527b, October, 2004, at 7, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/04_527b.pdf> (accessed June, 2017). For a comprehensive exposition of the Lamfalussy Process: see Eilís Ferran, *Building an EU Securities Market* (Cambridge University Press, 2004), at 58–111.
69 Niamh Moloney, 'The Lamfalussy Legislative Model: A New Era for the EC Securities and Investment Services Regime' (2003) 52 *The International and Comparative Law Quarterly* 509, at 516–517.
70 Rosa María Lastra, *Legal Foundations of International Monetary Stability* (Oxford University Press, 2006), at 331–341.
71 Directive 2004/39/EC on markets in financial instruments, 2004 OJ L 145/1.
72 Zdenek Kudrna, 'Governing EU Financial Markets: Transaction Cost Approach' (ECPR General Conference 2011, Reykjavík), at 26–33.
73 European Commission, Commission Staff Working document – Instruments for a modernised single market policy, SEC(2007) 1518, November, 2007, at 8, available at: <http://ec.europa.eu/citizens_agenda/docs/sec_2007_1518_en.pdf> (accessed June, 2017).

3.2. ESMA's Rule-Making Powers Conferred by De Larosière Reforms

As discussed above, Level 3 Committees of the Lamfalussy process have only some soft-law powers. Theoretically, in some instances, guidelines and recommendations have been recognised as having legal value in court cases where they were considered good practice,[74] so these soft-law (non-binding) tools are not devoid of *de jure* effect. However, the embryonic soft-law tools being developed within the previous Level 3 committees was proven to be ineffective in the wake of the global financial crisis of 2008–9: for example, an unsuccessful experiment with a soft-law approach to the regulation of credit rating agencies demonstrates the urge to 'upgrade' to a higher binding power remains strong;[75] another example regarding failures of the soft-law approach can also be found in the deposit guarantee schemes.[76] Due to the failure of these cases, the de Larosière Report, which was published in 2009 early,[77] brought about a shift of responsibilities towards the European institutions at the expense of national authorities. The result was the European System of Financial Supervision ('ESFS') was established, comprising the European Systemic Risk Board ('ESRB'), the

[74] CJEU, Case C-322/88, *Grimaldi v Fonds des maladies professionnelles*, [1989] ECR 04407, para. 18.
[75] European Commission, Communication 2006/C 59/02 from the Commission on Credit Rating Agencies, 2006 OJ C59/2 (soft law); Regulation (EC) No 1060/2009 on credit rating agencies, 2009 OJ L302/1 (hard law). See further at:
<http://ec.europa.eu/finance/rating-agencies/index_en.htm> (accessed June, 2017).
[76] European Commission, Communication from the Commission to the European Parliament and the Council concerning the review of Directive 94/19/EC on Deposit Guarantee Schemes, COM(2006) 729 final, November, 2006 (soft law); Directive 2014/49/EU on deposit guarantee schemes, 2014 OJ L173/149 (hard law). See further at: <http://ec.europa.eu/finance/bank/guarantee/index_en.htm> (accessed June, 2017).
[77] See European Commission, Report of the High-Level Group on Financial Supervision in the EU, February, 2009, Ch. III, available at:
<http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf>
(accessed June, 2017). ('de Larosière report')

European Supervisory Authorities ('ESAs'), the Joint Committee of ESAs and Member States' national competent authorities ('NCAs').[78] ESAs include three authorities: (i) the European Banking Authority ('EBA')[79], (ii) the European Insurance and Occupational Pensions Authority ('EIOPA'),[80] and (iii) the European Securities and Markets Authority ('ESMA').[81] ESMA is in charge of European capital markets regulation replaced the advisor-only CESR on 1 January, 2011. As some scholar said, 'minimum harmonised legislation is nearly abandoned' by conferring ESMA stronger binding powers on rule making.[82] An important manifestation of the changes is the implementation of a Single Rulebook via ESMA,[83] for tackling the lack of a consistent set of rules.[84] Attributed to the de Larosière reforms, ESMA now not only undertakes the CESR's old role in providing technical advice, but also has new powers to issue opinions,[85] draft technical standards[86] and publish guidelines and recommendations in the rule-making process.[87] These matters are discussed in more detail below.

First, ESMA has taken over the CESR's previous role as an expert technical adviser

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[78] For a detailed institutional structure of ESFS: see Eilís Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision' in Eddy Wymeersch, Klaus J. Hopt and Guido Ferrarini (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (Oxford University Press, 2012), at 111–158.
[79] Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, 2010 OJ L331/12. ('EBA Regulation')
[80] Regulation (EU) No 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC, 2010 OJ L331/48. ('EIOPA Regulation')
[81] Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC, 2010 OJ L331/84. ('ESMA Regulation')
[82] Stuart Willey, 'The European System of Financial Supervision' in Michael C. Blair, George Alexander Walker and Stuart Willey (eds), *Financial Markets and Exchanges Law* (2nd edn, Oxford University Press, 2012), at 388.
[83] Recital 5 of ESMA Regulation.
[84] The de Larosière report, above note 77, paras. 99–104.
[85] Article 8.2(g) of ESMA Regulation.
[86] Articles 8.2(a) and (b) of ESMA Regulation.
[87] Articles 8.2(c) of ESMA Regulation.

to the Commission's Level 2 rules,[88] albeit the types and rule-making process of Level 2 rules were changed. After the Lisbon Treaty,[89] signed in 2007 and renamed the TEC as the TFEU, and which came into force on 1 December, 2009, Article 290 of the TFEU created a new category of legal act at Level 2: 'delegated acts'. Level 1 legislation may delegate the Commission power to adopt non-legislative acts of general application to supplement or amend certain non-essential elements. The Expert Group of the ESC, as a consultative entity of the Internal Market and Services Directorate General ('DG MARKT') in the Commission, has a particular role in the preparation of delegated Acts regarding securities law.[90] Moreover, Article 291 of the TFEU also strengthens the implementing powers of the Commission, although the Commission could neither amend nor supplement the legislative Act in exercising these implementing powers, even as to its non-essential elements.[91] In case the European measures require uniform implementation across the EU, the Commission is authorised to adopt 'implementing acts' relating to the securities field with the assistance of the ESC.[92] The new procedure and the Parliament's involvement under Article 291 were also added.[93] In addition to providing technical advice as the CESR did, ESMA, upon a request or on its own initiative, has a new power to provide opinions to the Parliament, the Council and the

88 Article 8.1(l) of ESMA Regulation.

89 Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, 2007 OJ C 306/1.

90 See EGESC website, available at: <http://ec.europa.eu/finance/securities/egesc/index_en.htm> (accessed June, 2017).

91 CJEU, Case C-65/13, *Parliament v Commission*, [2014] ECLI:EU:C:2014:2289, para. 45.

92 For example, Article 51 of MiFIR.

93 Regulation (EU) No 182/2011 of the European Parliament and of the Council laying down the rules and general principles concerning mechanisms for control by Member States of the Commission's exercise of implementing powers, 2011 OJ L55/13.

Commission on all issues to its area of competence.[94]

Second, according to Articles 10 and 15 of Regulation (EU) No 1095/2010 ('ESMA Regulation'), ESMA can develop regulatory technical standards ('RTSs') and implementing technical standards ('ITSs') by means of regulations or decisions, in accordance with the procedure of Articles 290 and 291 of the TFEU respectively. ESMA now has a new power to draft technical standards which are 'binding' to Member States.[95] Essentially, ESMA's power in drafting technical standards should be seen as a conferral of competence from the Commission, so, technical standards should be compatible with those Level 2 rules.[96] Also, technical standards shall not involve 'strategic decisions or policy choices'.[97] The adoption of technical standards is subject to the Commission's endorsement, and the Parliament and the Council have veto powers to participate in the adoption of RTSs.[98] By means of the foregoing reforms, Level 2 legislation with binding powers extends to two types: (i) 'Commission-only' acts with ESAs' support: delegated acts and implementing acts; and (ii) 'ESAs plus Commission' acts: RTSs and ITSs.[99]

Third, ESMA, 'with a view to establishing consistent, efficient and supervisory practices and to ensuring the common, uniform and consistent application of Union

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[94] Article 34.1 of ESMA Regulation.
[95] Article 17 of ESMA Regulation.
[96] Recital 13 of Directive 2010/78/EU amending Directives 98/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC and 2009/65/EC in respect of the powers of the European Supervisory Authority (European Banking Authority), the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority), 2010 OJ L331/120. ('Omnibus Directive')
[97] Articles 10 and 15 of ESMA Regulation.
[98] Articles 11–14 of ESMA Regulation.
[99] Eddy Wymeersch, 'The European Financial Supervisory Authorities or ESAs' in Eddy Wymeersch, Klaus J. Hopt and Guido Ferrarini (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (Oxford University Press, 2012), at 250–251.

Law', can also issue non-binding guidelines and recommendations to NCAs, as CESR did, or even to market participants.[100] Nevertheless, a key difference is local supervisors and market actors now shall 'make every effort to comply with' these non-binding guidelines and recommendations, which is supported by a novel 'comply or explain' mechanism and public disclosure of non-compliance.[101] These non-binding guidelines and recommendations could hence be considered as secondary sources of law, having their 'hard' quality.[102] Professor Möllers even coins them as the 'hoft law', which is a third type of law, beside hard law and soft law.[103] Likewise, a new justification of issuing guidelines and recommendations is added: ESMA may adopt guidelines and recommendations 'with a view to promoting the safety and soundness of markets and convergence of regulatory practice'.[104] Although guidelines are in place everywhere to clarify the application of regulatory rules, it is important to note that the CJEU set down that guidelines shall follow the general principles of law (such as, the equal treatment and the protection of legitimate expectations) if the guidelines are designed to produce external effects.[105]

On the whole, the multi-level rule-making system of investment conduct regulation can be understood as set out in Figure II-1 below. Indeed, some issues still exist in the

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[100] Article 16 of ESMA Regulation; compare Article 3 of CESR Decision.

[101] Article 16.3 of ESMA Regulation. See also ESMA, Frequently Asked Questions: A Guide to Understanding ESMA, ESMA/2011/009, January, 2011, at 5, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2011_009.pdf> (accessed June, 2017).

[102] N. Moloney, *EU Securities and Financial Markets Regulation*, above note 61, at 930.

[103] Thomas M. J. Möllers, 'Sources of Law in European Securities Regulation - Effective Regulation, Soft Law and Legal Taxonomy from Lamfalussy to de Larosière' (2010) 11 *European Business Organization Law Review* 379, at 400.

[104] Article 9.2 of ESMA Regulation.

[105] CJEU, Joined Cases C-189/02 P, C-202/02 P, C-205/02 P to C-208/02 P and C-213/02 P, *Dansk Rørindustri and Others v Commission*, [2005] ECR I-5425, paras. 209–211.

current system.[106] However, the rule-making procedure added by the de Larosière reforms into the 'Lamfalussy II process' must be regarded positively with respect to the role of ESMA, enabling the use of its expertise and reducing the necessity of the lengthy European legislative procedures.[107]

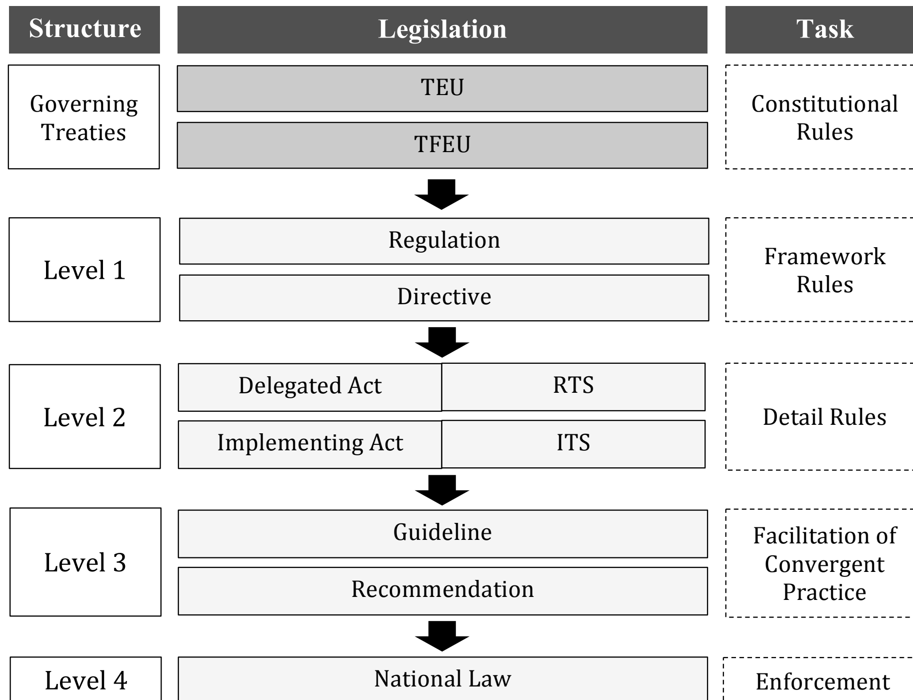

Figure II-1: Rule-Making System of Investment Conduct Regulation in the EU

3.3. Exhaustively Harmonised Rules in MiFID Regime

The first initiative to harmonise the rules of investment conduct in the EU may be traced back to the Commission Recommendation in 1977,[108] followed by a list of general principles in Article 11 of ISD in 1993.[109] Thereafter, MiFID I, together with

[106] See further in Section 4 below (pp. 61–71).
[107] Fabian Fabian Walla, 'Process and Strategies of Capital Markets Regulation in Europe' in Rüdiger Veil (ed), *European Capital Markets Law* (Hart Publishing, 2013) in Rüdiger Veil (ed), *European Capital Markets Law* (Hart Publishing, 2013), at 35–36.
[108] European Commission, Commission Recommendation 77/534/EEC concerning a European code of conduct relating to transactions in transferable securities, 1977 OJ L212/37.
[109] Council Directive 93/22/EEC on investment services in the securities field, 1993 OJ L141/27. ('ISD')

relative Level 2 legislation[110] as 'MiFID I Regime', was applied by all Member States in 2007, and the rules of investment conduct were harmonised largely in the EU.[111] In 2014, a revised MiFID[112] introduced some updated 'minimum harmonised' [113] rules of investment conduct (known as 'MiFID II'), together with a new Regulation on Markets in Financial Instruments ('MiFIR').[114] Both of them are going to be implemented and applied by Member States from January, 2018.[115] Likewise, a Regulation on key information documents for packaged retail and insurance-based investment products ('KID Regulation')[116] was directly applicable from 31 December, 2016,[117] as a complement to the measures on distribution of whole 'MiFID II Package'.[118] At the

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110 Commission Directive 2006/73/EC implementing Directive 2004/39/EC as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, 2006 OJ L241/36 ('Level 2 Directive of MiFID I'); Commission Regulation (EC) No 1287/2006 implementing Directive 2004/39/EC as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive, 2006 OJ L241/1. ('Level 2 Regulation of MiFID I')

111 The precise level of harmonisation in MiFID I is debatable, because the only relative provision is in Article 4 of Level 2 Directive rather than in MiFID I: see Michel Tison, 'Financial Market Integration in the Post FSAP Era. In Search of Overall Conceptual Consistency in the Regulatory Framework' in Guido Ferrarini and Eddy Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, The MiFID and Beyond* (Oxford University Press, 2006), at 445–451.

112 Directive 2014/65/EU on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, 2014 OJ L173/349. ('MiFID II')

113 See Articles 16.11 and 24.12 of MiFID II. However, Moloney argues these provisions in MiFID II are regarded as *de facto* maximum harmonisation because Member State may only impose additional requirement in 'exceptional cases': see N. Moloney, *EU Securities and Financial Markets Regulation*, above note 61, at 790–791.

114 Regulation (EU) No 600/2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, 2014 OJ L173/84. ('MiFIR')

115 Originally, MiFID II and MiFIR were planned to be implemented and applied by Member States from January, 2017 (Article 93 of MiFID II and Article 55 of MiFIR). However, due to the complicated requirements of IT system update, MiFID II/MiFIR's implementation is postponed to January, 2018. See Directive (EU) 2016/1034 amending Directive 2014/65/EU on markets in financial instruments, 2016 OJ L175/8; and Regulation (EU) 2016/1033 amending Regulation (EU) No 600/2014 on markets in financial instruments, Regulation (EU) No 596/2014 on market abuse and Regulation (EU) No 909/2014 on improving securities settlement in the European Union and on central securities depositories, 2016 OJ L175/1.

116 Regulation (EU) No 1286/2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), 2014 OJ L352/2. ('KID Regulation')

117 Article 34 of KID Regulation.

118 Recital 5 of KID Regulation.

current stage, the Commission has adopted two delegated acts of MiFID II[119] and one of MiFIR[120], along with over forty technical standards.[121] Thanks to these efforts, rules of investment conduct now are harmonised more densely and exhaustively in the EU, representing a move towards the 'Single Rulebook' framework.[122] This is a significant development from 'capital markets law(s) in Europe' to 'European capital markets law'.[123] However, due to the limited space, it is unable to provide comprehensive discussion of Level 2 and Level 3 rules of MiFID II package here. The following discussion will focus on the harmonised Level 1 rules of investment conduct in the EU.

3.3.1. Clients' Classification

MiFID II is a major Directive on investor protection in the EU that deals with 'investment firms' and their relationship with their 'clients', amongst other things. MiFID II defines 'investment firms' as meaning 'any legal person whose regular occupation or business is the provision of one or more investment services to third

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[119] See Commission Delegated Directive (EU) .../... supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits, C(2016) 2031 final, April, 2016, available at: <http://ec.europa.eu/finance/securities/docs/isd/mifid/160407-delegated-directive_en.pdf> (accessed June, 2017) ('Delegated Directive of MiFID II'); and Commission Delegated Regulation (EU) .../... supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, C(2016) 2398 final, April, 2016, available at: <http://ec.europa.eu/finance/securities/docs/isd/mifid/160425-delegated-regulation_en.pdf> (accessed June, 2017). ('Delegated Regulation of MiFID II')

[120] Commission Delegated Regulation (EU) .../... supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions, C(2016) 2860 final, May, 2016, available at: <http://ec.europa.eu/finance/securities/docs/isd/mifid/160518-delegated-regulation_en.pdf> (accessed June, 2017). ('Delegated Regulation of MiFIR')

[121] The Commission provides an up-to-date overview table of these technical standards, available at: <http://ec.europa.eu/finance/securities/docs/isd/mifid/its-rts-overview-table_en.pdf> (accessed June, 2017).

[122] Christopher Leonard, Ezra Zahabi and Chris Poon, 'MiFID II: One Step Closer to A Common Rulebook?' (2015) 34 *International Financial Law Review* 1, at 1.

[123] Rüdiger Veil, 'Conclusion' in Rüdiger Veil (ed), *European Capital Markets Law* (Hart Publishing, 2013), at 474–478.

parties and/or the performance of one or more investment activities on a professional basis'.[124] In terms of 'clients', it means 'any natural or legal person to whom an investment firm provides investment or ancillary services'[125] with two types: (i) a 'professional client' 'means a client meeting the criteria laid down in Annex II';[126] and (ii) a 'retail client' 'means a client who is not a professional client'.[127] In accordance with the initial paragraph of Annex II of MiFID II, a retail investor is a client (may be either a natural or legal person) who does NOT 'possess experience, knowledge and expertise to make its own investment decision and to properly assess the risks that it incurs'.[128] Under such conditions, the asymmetric information[129] and principal-agent problems[130] between investment firms and retail clients are easily to become greater.[131] Therefore, the Level 2 rules of the MiFID regime (whether MiFID I or II) provide stronger protection on retail investors.[132] In contrast, there is no compelling reason for special

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124 Article 4.1(1) of MiFID II.
125 Article 4.1(9) of MiFID II.
126 Article 4.1(10) of MiFID II with reference to Annex II, which contains detailed guidance on how to classify an investor as professional.
127 Article 4.1(11) of MiFID II.
128 In accordance with this definition, the term 'retail investor' is not equal to the term 'consumer', because a 'consumer' shall be 'any natural person who is acting for purposes which are outside his trade, business or profession' (see Article 2(b) of Council Directive 93/13/EEC on unfair terms in consumer contracts, 1993 OJ L95/29; Article 2(e) of Directive 2000/31/EC on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market, 2000 OJ L178/1; Article 2(d) of Directive 2002/65/EC concerning the distance marketing of consumer financial services, 2002 OJ L271/16), or 'outside his craft' (Article 2(a) of Directive 2005/29/EC concerning unfair business-to-consumer commercial practices in the internal market, 2005 OJ L149/22). Furthermore, this definition shall not to be given a wider interpretation in the EU law: CJEU, Joined Cases C-541/99 and C-542/99, *Cape Snc v Idealservice Srl* and *Idealservice MN RE Sas v OMAI Srl*, [2001] ECR I-9049, para. 16.
129 In here, it means investment firms own more information and know more than their clients: see further in Section 3.1.1 of CHAPTER IV (p. 146).
130 In brief, since an investment firm has more knowledge or power than its client, it may abuse this position: see further in Section 3.1.2 of CHAPTER IV (pp. 148–149).
131 David T. Llewellyn, 'Regulation of Retail Investment Services' (1995) 15 *Economic Affairs* 12, at 14; Charles AE Goodhart, 'Some Regulatory Concerns' (1996) 132 *Swiss Journal of Economics and Statistics* 613, at 618–620; Charles Goodhart et al, *Financial Regulation: Why, How and Where Now?* (Bank of England, 1998), at 7–8.
132 This can be found in the information requirements (such as, Article 48.1 and 50.1 of Delegated Regulation of MiFID II), the documenting and reporting requirements (such as, Article 61 of Delegated Regulation of MiFID II), the know your clients requirements (such as, Articles 54.3 and 56.1 of Delegated

protection on professional, wholesale investors, and such investors dominate markets, since they understand the risks.[133] This distinction of retail/professional investors is also applied by many jurisdictions in the world, albeit this is not without critics.[134]

In addition to retail/professional investors, there is a third type of clients in the MiFID regime: 'eligible counterparties'.[135] They can benefit from significant exemptions from the rules of investment conduct (such as, the quality-of-service and best execution requirements that will be discussed below)[136] with regard to the investment services of 'executing orders on behalf of clients, and/or dealing on own account, and/or receiving and transmitting orders'.[137] However, 'in order to enhance the regulatory framework applicable to the provision of services irrespective of the categories of clients concerned',[138] now principles to 'act honestly, fairly and professionally' and the obligation to be 'fair, clear and not misleading' (but the obligation to act in accordance with the best interest of its client is not extended) apply to the relationship with eligible

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Regulation of MiFID II), the order execution requirements (such as, Article 64.1 of Delegated Regulation of MiFID II) and other miscellaneous requirements (such as, safekeeping clients' assets in Article 2.3 of Delegated Directive of MiFID II). For a detailed analysis of this in MiFID I's Level 2 rules: see Marc Kruithof, 'A Differentiated Approach to Client Protection: The Example of MiFID' in Stefan Grundmann and Yesim M. Atamer (eds), *Financial Services, Financial Crisis and General European Contract Law: Failure and Challenges of Contracting* (Kluwer Law International, 2011), at 123–147.

133 European Commission, White Paper on Enhancing the Single Market Framework for Investment Funds, COM(2006)686 final, 15 November, 2006, at 13, available at: <http://ec.europa.eu/internal_market/securities/docs/ucits/whitepaper/whitepaper_en.pdf> (accessed June, 2017).

134 For example, Professor Bradley argues that the emergence of day traders invites us to reconsider the bases of this distinction: see Caroline Bradley, 'Disorderly Conduct: Day Traders and the Ideology of "Fair and Orderly Markets"' (2000) 26 *Journal of Corporation Law* 63, at 90.

135 According to Article 30.2 of MiFID II, eligible counterparties include 'investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, other financial institutions authorised or regulated under Union law or under the national law of a Member State, national governments and their corresponding offices including public bodies that deal with public debt at national level, central banks and supranational organisations.'

136 See Sections 3.3.6 and 3.3.7 below (pp. 48–56).

137 Article 30.1 of MiFID II.

138 Recital 86 of MiFID II.

counterparties.[139] Also, 'the financial crisis has shown limits in the ability of non-retail clients to appreciate the risk of their investment',[140] so some information and reporting requirements are now extended to apply to eligible counterparties.[141]

In summary, there are three types of investors classified in the MiFID regime: retail investors, professional investors and eligible counterparties; and, in accordance with the Prospectus Directive, later two types can further be called together as 'qualified investors'.[142] These three types of clients enjoy different ambits of protection, reflecting a concern of regulatory efficiency: namely, '[m]easures to protect investors should be adapted to the particularities of each category of investors'.[143] This tailored regulation can be regarded as 'asymmetrically paternalistic', bridging the gap between discipline through market forces and paternalistic regulatory intervention.[144]

3.3.2. General Requirement

According to Article 24.1 of MiFID II, 'when providing investment services and/or, where appropriate,[145] ancillary services to clients,'[146] an investment firm is required to 'act honestly, fairly, and professionally in accordance with the best interest

139 Article 30.1 of MiFID II; see further in Article 71 of Delegated Regulation of MiFID II.
140 Recital 104 of MiFID II.
141 See further in Article 30.1 of MiFID II.
142 Article 2.1(e) of Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, 2003 OJ L345/65; amended by Directive 2008/11/EC of the European Parliament and of the Council, 2008 OJ L76/37, and Directive 2010/73/EU of the European Parliament and of the Council, 2010 OJ L327/1. ('Prospectus Directive') See further in Recital 7 of Directive 2010/73/EU, 2010 OJ L327/1.
143 Recital 86 of MiFID II.
144 Colin Camerer et al, 'Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism"' (2003) 151 *University of Pennsylvania Law Review* 1211, at 1236–1237. See also Section 3.1.4 of CHAPTER IV (pp. 151–153).
145 Without any further clarification, some concern the wording 'where appropriate' may leave some discretion to Member States in determining whether the general duty should apply to particular ancillary services; see Rob Price, 'Conduct of Business Standards – Fair Dealing for Clients' in Matthew Elderfield (ed), *A Practitioner's Guide to MiFID: The Markets in Financial Instruments Directive* (1st edn, Sweet & Maxwell Ltd, 2007), at 148–149.
146 Even when a firm is not providing any services, another similar obligation based on a different legal basis may still be applied: see Article 24 of MiFIR.

of its client', as a fundamental fiduciary-style obligation.[147] This general requirement, as an improvement on the static test, has 'an operational focus and sets an on-going standard of conduct expected of a license holder'.[148] The importance of this requirement is two-fold. First, it imposes positive obligations on investment firms,[149] and provides an *ex post* mechanism for reviewing the behaviour of investment firms.[150] Second, given the opacity of the concepts used (notably 'fairness'), it provides flexibility with respect to risks not expressly addressed.[151]

3.3.3. Marketing Requirement

A core marketing obligation is found in Article 24.3 of MiFID II, requiring that all information (including 'marketing communications') provided by an investment firm to (potential) clients must be 'fair, clear and not misleading'. Although there is no clear definition of the term 'marketing communications',[152] the absence of such a definition is likely to be less significant in practice, since the information requirement that will be discussed in the next section can cover the term sufficiently.[153] 'Marketing

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[147] Jean-Pierre Casey and Karel Lannoo, *The MiFID Revolution* (Cambridge University Press, 2009), at 46. For further discussion about the fiduciary duties: see Section 4.2.3 of CHAPTER V (pp. 230–234).
[148] Paul Latimer and Philipp Maume, *Promoting Information in the Marketplace for Financial Services: Financial Market Regulation and International Standards* (Springer Publishing, 2015), at 129.
[149] Alastair Hudson, *The Law of Finance* (2nd edn, Sweet & Maxwell, 2013), para. 10-16.
[150] N. Moloney, *EU Securities and Financial Markets Regulation*, above note 61, at 800.
[151] Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge University Press, 2010), at 218; Christel M. Grundmann-van de Krol, 'The Markets in Financial Instruments Directive and Asset Management' in Danny Busch and Deborah A. DeMott (eds), *Liability of Asset Managers* (Oxford University Press, 2012), at 45–46.
[152] The only relevant clarification of this term is given in Article 36.2 of Delegated Regulation of MiFID II. It defines an investment recommendation should be treated as a marketing communication once this recommendation does not meet the conditions of investment research.
[153] Rob R. Price, 'Conduct of Business Standards – Information Requirements' in Elderfield M (ed), *A Practitioner's Guide to MiFID: The Markets in Financial Instruments Directive* (1st edn, Sweet & Maxwell Ltd 2007), at 223. See also ESMA, MiFID – Conduct of Business, fair, clear and not misleading information: Peer Review Report, ESMA/2014/1485, December, 2014, paras. 14 and 15, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1485_peer_review_report_-_mifid_-_conduct_of_business_fair_clear_and_not_misleading_information.pdf> (accessed June, 2017).

communications' typically represent the initial stage in the investment process, which may have a 'material effect' on the investment decision than other stages of the sales process.[154] Thus, in order to prevent an undue impact on the commercial activities of investment firms, this requirement should be applied in an appropriate and proportionate way.

However, given the evidence of vulnerability of investors on marketing with respect to the over-confidence bias,[155] the marketing requirement become more and more stringent. For instance, MiFID II requires a match between financial instruments that investment firms manufacture (or offer/recommend) and their 'identified target market'.[156] This is a product governance procedure required for product distributors, imposing an overarching obligation on investment firms to consider clients' interests when distributing products through any channel.[157] Furthermore, the KID Regulation is in place with an aim to help retail investors understand and compare the key features and risks of the packaged retail and insurance-based investment products ('PRIIPs').[158] Marketing communications of PRIIPs 'shall not include any statement that contradicts the information contained in the key information document or diminishes the significance of the key information document'.[159]

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[154] CESR, Technical Advice on Possible Implementing Measures of Directive 2004/39/EC: 1st Set of Mandates, CESR/05-024c, January, 2005, at 45, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/05_024c.pdf> (accessed June, 2017).

[155] Gregory La Blanc and Jeffrey J. Rachlinski, 'In Praise of Investor Irrationality' in Francesco Parisi and Vernon L. Smith (eds), *The Law and Economics of Irrational Behavior* (Stanford University Press, 2005), at 558.

[156] Articles 24.2 and 24.4(b) of MiFID II. See also Articles 9 and 10 of Delegated Directive of MiFID II.

[157] N. Moloney, *EU Securities and Financial Markets Regulation*, above note 61, at 800.

[158] Article 1 of KID Regulation.

[159] Article 9 of KID Regulation.

3.3.4. Information Requirement

In addition to the shared provision with the marketing requirement to require information be 'fair, clear and not misleading',[160] the core disclosure provision of MiFID II requires an investment firm to provide appropriate information in 'good time' to clients and potential clients about the investment firm and services provided, the financial instruments involved, the proposed investment strategies (including risk warnings and execution venues), and related costs and associated charges.[161] For determination of the 'good time', 'the investment firm should take into account, having regard to the urgency of the situation, the client's need for sufficient time to read and understand it before taking an investment decision'.[162] In addition, the information requirement on costs and charges requires the investment firm not only to inform clients about all costs and charges related to both the investment/ancillary services and the financial instruments, but also to aggregate them in order to let clients understand the 'overall costs, as well as the cumulative effect on return of the investment'.[163] Likewise, a cross-selling provision for tackling issues of packaged products and bundle of services is newly introduced in MiFID II:[164] due to the complexity, investment firms shall inform their clients whether it is possible to buy the different components separately with comparable costs and risks.[165] However, the wide range of information places a concern regarding an investor's capacity to understand sophisticated financial

160 Article 24.3 of MiFID II. See detailed requirements in Article 44 of Delegated Regulation of MiFID II.
161 Article 24.4 of MiFID II. See further details in Articles 46–50 of Delegated Regulation of MiFID II.
162 Recital 83 of MiFID II.
163 Article 24.4 of MiFID II.
164 Recital 81 of MiFID II.
165 Article 24.11 of MiFID II.

information and may simply generate confusion.[166] Therefore, MiFID II further requires the information should be 'in a comprehensible form' that clients or potential clients are 'reasonably able to understand the nature and risks' for taking investment decisions on an informed basis.[167] Some may claim this wording recognises the investor's limited cognition, opening up 'a leeway to design the EU securities regulation right from the start in a behavioural way'.[168] This is very different to the traditional disclosure requirement.

Furthermore, due to the fact that retail investors may not be able to understand structured products, appropriate information regarding the characteristics of each product should be disclosed to retail investors.[169] The KID Regulation, thus, introduces simpler and standardised product information of PRIIPs, with an aim to build 'the trust of retail investors in the financial markets'.[170] A KID is a stand-alone document, separating from marketing material and any other disclosures required under other regimes which continue to exist in parallel.[171] It constitutes key pre-contractual information that should be 'accurate, fair, clear, not misleading' and 'consistent with' all other information about PRIIPs.[172] KIDs, normally,[173] are required to be provided to

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166 Niamh Moloney, 'Large-Scale Reform of Investor Protection Regulation: The European Union Experience' (2007) 4 *Macquarie Journal of Business Law* 147, at 171–172.
167 Article 24.5 of MiFID II.
168 Kai Purnhagen, 'Why Do We Need Responsive Regulation and Behavioural Research in EU Internal Market Law?' in Klaus Mathis (ed), *European Perspectives on Behavioural Law and Economics* (Springer, 2015), at 65.
169 ESMA, Economic Report: Retailisation in the EU, No1 2013, ESMA/2013/326, July, 2013, at 6, available at: <https://www.esma.europa.eu/system/files_force/library/2015/11/2013-326_economic_report_-_retailisation_in_the_eu_0.pdf?download=1> (accessed June, 2017).
170 Recital 5 of KID Regulation.
171 Article 6.2 of KID Regulation.
172 Article 6.1 of KID Regulation.
173 See two exceptions of the providing time in Articles 13.3 and 13.4 of KID Regulation.

retail investors or their behalves with written authority before concluding a sale.[174] Furthermore, KIDs shall be free of charge and may be provided either on paper, durable mediums or websites.[175] Overall, information requirements in the KID Regulation, which establish uniform rules on transparency, are complementary to the measures of MiFID II,[176] aiming to enhance investor protection at the EU level.[177]

However, the scope and relative importance of KIDs is open to debate.[178] First, given the limitations of disclosure highlighted by behavioural economics research, the reforms regarding key or simplified information may have limited effectiveness.[179] A further concern as to the ineffectiveness of information requirements is the time delay for information disclosure between the emergence of the 'evil' in the market and the enactment of the law to correct the 'evil'.[180] Inasmuch as the simple information rules are only ever going to be partially effective, or even fail,[181] clients shall be protected by an enhanced risk disclosure obligation.[182] Given the aforementioned suspicion that the information requirement may not always function orderly, some behavioural economics

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174 Articles 13.1 and 13.2 of KID Regulation.
175 Article 14 of KID Regulation.
176 Recital 5 of KID Regulation.
177 Recital 4 of KID Regulation.
178 Godwin and Ramsay conduct a comparative analysis of six jurisdictions, showing that rules of short-form disclosure documents are significantly varied: see Andrew Godwin and Ian Ramsay, 'Financial Products and Short-Form Disclosure Documents: A Comparative Analysis of Six Jurisdictions' (2015) 10 *Capital Markets Law Journal* 212, at 212–238.
179 Specifically, some scholars conducted an experiment finding that summary prospectuses on mutual funds did not lead to different purchasing decisions than much more detailed (and complex) statutory prospectuses for the same products: see John Beshears et al, 'How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices?' in David A. Wise (ed), *Explorations in the Economics of Aging* (University of Chicago Press, 2011), at 76–96.
180 John J. A. Burke, 'Re-Examining Investor Protection in Europe and the US' (2009) 16 *eLaw Journal* 1, at 17–18.
181 See, e.g., Omri Ben-Shahar and Carl E. Schneider, *More Than You Wanted to Know: The Failure of Mandated Disclosure* (Princeton University Press, 2014), Part II.
182 Donald C. Langevoort, 'Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers' (1996) 84 *California Law Review* 627, at 692–695.

scholars call for an enhancement of the point-of-sale ('POS') regulation, focusing on the quality of services and the mitigation of conflicts of interest instead.[183]

3.3.5. Conflict-of-Interest Requirement

Although the obligation to avoid prejudicial conflicts of interest between investment firms and their clients might be considered as being implied in the general requirement aforementioned, the conflict-of-interest requirements are expressly addressed by many self-standing provisions of MiFID II (such as, Articles 9.3, 16.3 and 23). This is because, even the general requirement under Article 24.1 concerning acting in the client's 'best interests' is closely related to (or even partially overlapping with) the conflict-of-interest requirement,[184] these two regimes operate independently: a breach of the conflict-of-interest requirement does not automatically lead to a breach of the general requirement and *vice versa*.[185] For example, an investment firm may provide its investment advice in accordance with the best interest of one client, but the recommended financial instrument is linked to the personal interest of the investment firm's managers.

Essentially, the conflict-of-interest requirement is not only an organisational requirement but also a conduct requirement.[186] On the one hand, in Article 9.3 of MiFID II, as an organisational requirement, interests of clients and conflict-of-interest management are placed at the heart of the management body's responsibilities.

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[183] Rainer Baisch and Rolf H. Weber, 'Investment Suitability Requirements in the Light of Behavioural Findings: Challenges for a Legal Framework Coping with Ambiguous Risk Perceptions' in Klaus Mathis (ed), *European Perspectives on Behavioural Law and Economics* (Springer, 2015), at 171–174.
[184] This overlap is noted by Article 24.9 of MiFID II.
[185] R. Price, 'Conduct of Business Standards – Fair Dealing for Clients', above note 145, at 150
[186] Guido Ferrarini, 'Contract Standards and the Markets in Financial Instruments Directive (MiFID): An Assessment of the Lamfalussy Regulatory Architecture' (2005) 1 *European Review of Contract Law* 19, at 33–35.

According to Article 16.3 of MiFID II, 'firms must maintain and operate organisational and administrative arrangement with a view to taking all reasonable steps[187] to prevent conflicts of interest from adversely affecting client interests'. In some cases that organisational and administrative arrangements are not sufficient 'with reasonable confidence' that risks of damage to client interests will be prevented, the investment firm shall clearly disclose this in a durable medium and in detail to the client before undertaking business.[188] However, this disclosure is a 'last resort', which is not a substitute for the conflict-of-interest identification and management.[189] Furthermore, investment firms shall take 'all appropriate steps to identify' conflicts of interest required by Article 23.1 of MiFID II.[190] Compared to the standard of 'reasonable steps' to 'prevent' conflicts of interest, the standard of 'appropriate steps' to 'identify' conflicts of interest is higher because of its objective assessment.[191] This difference may be caused by the different degrees of difficulty between identifying and preventing conflicts of interest. The former is easier than the latter. Therefore, in practice, investment firms need to set up different processes and control systems in different stages, in order to fulfil these two different standards.[192]

On the other hand, the conflict-of-interest requirement is diffused into the conduct

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[187] The 'reasonable steps' implies that investment firms may take into account the nature of the relevant business, but are not expected to go to disproportionate lengths to manage conflicts: see Michael Raffan, 'Conduct of Business Standards – Organisational Requirements' in Matthew Elderfield (ed), *A Practitioner's Guide to MiFID: The Markets in Financial Instruments Directive* (1st edn, Sweet & Maxwell Ltd, 2007), at 125.
[188] Articles 23.2 and 23.3 of MiFID II.
[189] C. M. G.-v. d. Krol, above note 151, at 39.
[190] For detailed requirements of 'appropriate steps': see Article 33 of Delegated Regulation of MiFID II.
[191] N. Moloney, *EU Securities and Financial Markets Regulation*, above note 61, at 373.
[192] For the detailed differences of these two standard: see further in Article 34 of Delegated Regulation of MiFID II regarding 'conflicts of interest policy'.

requirement in Article 24 of MiFID II.[193] This could not only prove that the conflict-of-interest requirement is part of the investment conduct rules, rather than a pure organisational requirement, but also prevent a wrongful over-reliance on organisational arrangements to tackle conflict-of-interest issues.[194] One important change here is that 'independent advice' is now clearly distinguished from 'non-independent advice'.[195] The distinction between these two is whether investment firms 'accept and retain fees, commissions or any monetary and non-monetary benefits from third parties'.[196] Once an investment firm informs the client that investment advice is provided on an 'independent basis', the investment firm shall assess a 'sufficient diverse range' of financial instruments available on the market, which must not be limited to financial instruments issued or provided by the investment firm or by entities that have relationships with the investment firm.[197] However, some paradoxical results show such a disclosure-based division of investment advice can have perverse effects: first, clients generally underestimate the influence of the disclosed conflicts of interest;[198] second, disclosure can even exaggerate the problem caused by conflicts of

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193 Articles 24.7, 24.8, and 24.10 of MiFID II.

194 Luca Enriques, 'Conflicts of Interest in Investment Services: The Price and Uncertain Impact of MiFID's Regulatory Framework' in Guido Ferrarini and Eddy Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, The MiFID and Beyond* (Oxford University Press, 2006), at 331–334.

195 Article 24.4(a) of MiFID II and Article 52 of Delegated Regulation of MiFID II.

196 Recital 74 of MiFID II.

197 Recital 73 and Article 24.7 (a) of MiFID II; see further in Article 53 of Delegated Regulation of MiFID II.

198 Daylian M. Cain, George Loewenstein and Don A. Moore, 'The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest' (2005) 34 *The Journal of Legal Studies* 1, at 5–7 and 22; Marc Kruithof, 'Conflicts of Interest in Institutional Asset Management: Is the EU Regulatory Approach Adequate?' in Luc Thévenoz and Rashid Bahar (eds), *Conflicts of Interest: Corporate Governance and Financial Markets* (Kluwer Law International, 2007), at 326–327; Christoph Kumpan and Patrick C. Leyens, 'Conflicts of Interest of Financial Intermediaries: Towards a Global Common Core in Conflicts of Interest Regulation' (2008) 5 *European Company and Financial Law Review* 72, at 89.

interest, because the advisors feel themselves are conferred with a 'moral license'.[199]

In addition to the foregoing disclosure requirement, MiFID II further requires that when providing investment advice on an independent basis,[200] or providing services of portfolio management[201], investment firms shall 'not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients'.[202] This aims to prevent misaligned incentives of compensation structures between investment firms and their clients that will aggravate the principle-agent problem.[203] By means of the strict avoidance of conflicts of interest, this might be 'better suited to balance the behavioural anomalies than a mere disclosure'.[204] Overall, MiFID II establishes a disclosure-based division in combination with appropriate prevention, providing an 'efficient deterrent' to opportunistic behaviour of advisors.[205]

Yet, the foregoing mandatory separation of the independent advice from the non-independent advice in MiFID II might still be questioned. Because (i) not all clients will want to opt into the independent advice; and (ii) many clients would need to find a

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199 Daylian M. Cain, George Loewenstein and Don A. Moore, above note 198, at 7 and 22; George Loewenstein, Daylian M. Cain and Sunita Sah, 'The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest' (2011) 101 *The American Economic Review* 423, at 423–424.

200 Article 24.7 (b) of MiFID II.

201 Article 24.8 of MiFID II

202 See also Recital 75 of MiFID II and Article 12 of Delegated Directive of MiFID II.

203 Professor Jackson refers this issue as the 'trilateral dilemma' in the field of investment services: see Howell E. Jackson, 'The Trilateral Dilemma in Financial Regulation' in Annamaria Lusardi (ed), *Overcoming the Saving Slump: How to Increase the Effectiveness of Financial Education and Saving Programs* (University of Chicago Press, 2008), at 82–83 and 91–97.

204 Gerald Spindler, 'Behavioural Finance and Investor Protection Regulations' (2011) 34 *Journal of Consumer Policy* 315, at 329–330.

205 Bryan K. Church and Xi Kuang, 'Conflicts of Interest, Disclosure, and (Costly) Sanctions: Experimental Evidence' (2009) 38 *The Journal of Legal Studies* 505, at 509 and 527.

new advisor since their current advisors may not allow to offer two types of advice to them, there is a risk that the separation of independent/non-independent advice may result in less advice for the people who need it most.[206] In order to access by-products of some useful products and services, it might be impossible to eliminate all of this 'ethical pollution' arising from conflicts of interest.[207] As some argue, commissions are an important instrument that steers demand to the most efficient products, but the mandatory disclosure and bans/caps on commissions would stifle this function.[208] In practice, a perhaps more effective mechanism is to ensure that the remuneration schemes of the front-office sales staff are either (i) 'blind to the amount of commission revenue' linking to specific products in question; or (ii) 'neutral to sales volumes' of specific products.[209] Also, changing the system of commissions from the 'upfront type' into the 'trail type' (i.e., from the short-term into the long-term consideration) might also be another choice to dilute conflicts of interest.[210] In this sense, even in the absence of the separation between independent and non-independent services, Article 24.10 of MiFID II, along with an appropriate inducements regulation in Article 24.9, might be enough to prevent misconduct of investment firms already: namely, when providing investment services (no matter on an independent basis or not), an investment firms shall ensure that it do not remunerate or assess the performance of

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206 Andreas Hackethal and Andreas Hackethal, 'Financial Advice' in Ester Faia et al (eds), *Financial Regulation: A Transatlantic Perspective* (Cambridge University Press, 2015), at 257–258.
207 James Angel and Douglas McCabe, 'Ethical Standards for Stockbrokers: Fiduciary or Suitability?' (2013) 115 *Journal of Business Ethics* 183, at 191.
208 Roman Inderst and Marco Ottaviani, 'Competition through Commissions and Kickbacks' (2013) 102 *The American Economic Review* 780, at 780–809.
209 J.-P. Casey and K. Lannoo, above note 147, at 138.
210 Roman Inderst and Marco Ottaviani, 'Regulating Financial Advice' (2012) 13 *European Business Organization Law Review* 237, at 243–244.

their staff in a way that 'conflicts with its duty to act in the best interests of its clients'.[211]

3.3.6. Quality-of-Service Requirement

Since quality of investment services depends mostly on the natural person who providing services, an eligibility obligation in Article 25.1 of MiFID II requires investment firms shall ensure and demonstrate that 'natural persons giving investment advice or information about financial instruments, investment services or ancillary services to clients on behalf of the investment firm posses necessary knowledge and competence to fulfil their obligations' under Articles 24 and 25 of MiFID II.

Once the service is guaranteed to be provided by qualified people, the quality of service is further assessed under MiFID II in two ways: (i) the assessment of 'suitability',[212] and (ii) the assessment of 'appropriateness'.[213] These two assessments, which will be discussed in detail in the following paragraphs, have different scopes, functions and characteristics, depending on the degree of clients' reliance on the investment firm for investor choices.[214] Packaged products and bundle of services are also subject to the 'suitability' and 'appropriateness' tests.[215] Only execution-only services in 'non-complex products' provided at the initiative of the client, together with a prescribed warning and compliance with the conflict-of-interest regime, are not subject to the above assessments.[216] However, the range of 'non-complex products'

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211 Article 24.10 of MiFID II; see further in Article 27 of Delegated Regulation of MiFID II regarding remuneration policies and practices, together with Article 11 of Delegated Directive of MiFID II.
212 Article 25.2 of MiFID II.
213 Article 25.3 of MiFID II.
214 CESR, A Consumer's Guide to MiFID: Investing in Financial Products, CESR/08-003, March, 2008, at 6, available at:
<https://www.esma.europa.eu/sites/default/files/library/2015/11/08-003.pdf> (accessed June, 2017).
215 Articles 25.2(2) and 25.3(1) of MiFID II.
216 Article 25.4 of MiFID II.

exceptions is getting narrower. Article 25.4(a) of MiFID II, in comparison with Article 19.6(2) of MiFID I, narrows the list of non-complex products,[217] in particular structured Undertakings for Collective Investment in Transferable Securities ('UCITS') will no longer be able to be sold on an execution-only basis.[218] Structured deposits, which are newly brought into MiFID II,[219] are also no longer allowed to be sold on an execution-only basis if it is difficult for the client to understand the risk of return or the cost of exiting before term.[220]

According to Article 25.2 of MiFID II, where a firm provides 'investment advice or portfolio management services', a suitability/know-your-client ('KYC') check is required, which is calibrated to the nature of the investor, the service and the investment: the investment firm shall obtain 'the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation including his ability to bear losses, and his investment objectives including his risk tolerance',[221] so as to enable the investment firm to recommend whether the investment services and financial instruments are suitable for that client or potential client. This detailed requirement of the requested information can be considered as 'a positive step towards an increased

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[217] In short, according to Article 25.4(a) of MiFID II, although there are more detailed exceptions, 'non-complex products' include (i) 'shares admitted to trading on a regulated market or on an equivalent third-country market or on a MTF'; (ii) 'bonds or other forms of securitised debt admitted to trading on a regulated market or on an equivalent third country market or on a MTF'; (iii) 'money-market instruments'; (iv) 'shares or units in UCITS'; (v) 'structured deposits'; and (vi) other non-complex financial instruments. For the criteria with respect to what other non-complex financial instruments are: see Article 57 of Delegated Regulation of MiFID II.

[218] This raises another issue about this criterion: whether the 'structured' UCITS can be considered as 'complex' product equally: see Jürgen Vandenbroucke, '(Non-)Complexity through the Eyes of MiFID' (2014) 37 *European Journal of Law and Economics* 477, at 477–488.

[219] Recital 39 and Article 1.4 of MiFID II.

[220] Article 25.4(a) of MiFID II.

[221] For detailed requirements: see Article 54 of Delegated Regulation of MiFID II.

individualisation of the provided investment services and reducing the risk of investment services with negative consequences'.[222] Also, MiFID II requires a comprehensive statement on 'suitability' to specify 'the advice given and how that advice meets the preferences, objectives and other characteristics of the retail client',[223] which 'ensures that the client does not incur a loss out as a result of the report presenting in an inaccurate or unfair manner the personal recommendation'[224] made by the investment firms to the client. However, it should be noted that this assessment does not appear to be a requirement to find the 'most suitable' transaction, so it may still be possible for a firm to comply with the requirement of this Article, even if there are other transactions that would have been more suitable.[225]

The 'appropriateness' test is under Article 25.3 of MiFID II: where non-advisory services are provided, and include, in particular, execution-only transactions in complex products, investment firms shall ask the client to provide information regarding the client's 'knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client'.[226] In contrast with the 'suitability' test, the client's financial situation and investment objectives are not required to be assessed within the 'appropriateness' test.[227] In case that 'the product or service is not appropriate to the client or potential client' based on

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[222] Martin Hobza, 'Investment Services and Protection of the Retail Client' (2015) 1 *The Lawyer Quarterly* 51, at 55.
[223] Article 25.6.2 of MiFID II.
[224] Recital 82 of MiFID II.
[225] R. Price, 'Conduct of Business Standards – Fair Dealing for Clients', above note 145, at 167–168.
[226] See further in Article 56 of Delegated Regulation of MiFID II.
[227] Compare Article 25.2 with Article 25.3 of MiFID II.

the information provided, or even the information is not provided by the client, investment firms have a risk warning obligation that may be provided in a standardised format.[228] However, unlike the suitability regime, the firm is still able to proceed with a transaction after this warning.[229] In addition, in order to keep evidence of the aforementioned suitability and appropriateness assessments,[230] MiFID II requires the keeping documentary records,[231] along with an additional provision on keeping recordings of telephone conversations and electronic communications.[232] It also requires investment firms to establish a documentary record of the firm/investor relationship with the on-going disclosure.[233]

However, boundaries of the aforementioned quality-of-service requirement are revealed by the behavioural economics research. First, the information required by the 'suitability' and 'appropriateness' tests is impossible to be collected from the clients without fault and bias.[234] Second, overconfident clients could still possibly appear: (i) they may use execution-only services in non-complex products to bypass the 'suitability' and 'appropriateness' tests; and (ii) they may submit unsolicited orders to investment firms and do not provide enough information for the 'appropriateness' test, and, as a result, firms, in this case, can just issue a warning which is of little value.[235] Given the

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228 Articles 25.3.2 and 25.3.3 of MiFID II.
229 R. Price, 'Conduct of Business Standards – Fair Dealing for Clients', above note 145, at 177.
230 Recitals 57 and 144 of MiFID II.
231 Articles 16.6 and 25.5 of MiFID II; see further in Articles 72–75 of Delegated Regulation of MiFID II.
232 Articles 16.7 and 25.6.3 of MiFID II; see further in Article 76 of Delegated Regulation of MiFID II.
233 Article 25.6.1 of MiFID II.
234 Andreas Oehler and Daniel Kohlert, 'Financial Advice Giving and Taking—Where are the Market's Self-healing Powers and a Functioning Legal Framework When We Need Them?' (2009) 32 *Journal of Consumer Policy* 91, at 99–102.
235 Lars Klöhn, 'Preventing Excessive Retail Investor Trading under MiFID: A Behavioural Law & Economics Perspective' (2009) 10 *European Business Organization Law Review* 437, at 445–447.

foregoing imperfection of the quality-of-service requirement, other tools are complementarily needed.

3.3.7. Best Execution Requirement

Although the 'best-execution' regime is initially designed to uphold 'integrity' and 'efficiency' in the new competitive order-execution market,[236] it is now critical for investor protection when investment firms provide services for executing orders to their clients. Therefore, where firms owe contractual or agency obligations to their clients, the investment firms shall 'execute client orders on terms that are most favourable to the client'.[237] Although the best execution requirement focuses on investment services regarding execution of orders, Level 2 rules of MiFID II extend it to portfolio management as well as reception and transmission of orders, on the basis of the general requirement concerning acting in the client's 'best interests'.[238] In short, the relationship between the best execution, the quality-of-service and the general requirements could be explained as following Table II-1 shows.

[236] Recital 13 of MiFID II. However, whether these aims could be achieved is questioned by scholars. See, e.g., Guido Ferrarini and Niamh Moloney, 'Reshaping Order Execution in the EU and the Role of Interest Groups: From MiFID I to MiFID II' (2012) 13 *European Business Organization Law Review* 557, at 579–580; David C Donald, 'Bridging Finance Without Fragmentation: A Comparative Look at Market Connectivity in the US, Europe and Asia' (2015) 16 *European Business Organization Law Review* 173, at 182–189.
[237] Recital 91 of MiFID II.
[238] Article 65 of Delegated Regulation of MiFID II.

Table II-1: Requirements of Investment Services

<table>
<tr><th colspan="2">Requirement / Type of Service</th><th>Suitability Requirement</th><th>Appropriateness Requirement</th><th>Best Execution Requirement</th><th>General Requirement</th></tr>
<tr><td colspan="2">Investment Advice</td><td>V</td><td></td><td></td><td>V</td></tr>
<tr><td colspan="2">Portfolio Management</td><td>V</td><td></td><td colspan="2">V</td></tr>
<tr><td rowspan="2">Execution of Orders on Behalf of Clients</td><td>Complex Products</td><td></td><td>V</td><td>V</td><td>V</td></tr>
<tr><td>Non-Complex Products</td><td></td><td></td><td>V</td><td>V</td></tr>
<tr><td rowspan="2">Reception and Transmission of Orders</td><td>Complex Products</td><td></td><td>V</td><td colspan="2">V</td></tr>
<tr><td>Non-Complex Products</td><td></td><td></td><td colspan="2">V</td></tr>
<tr><td colspan="2">Other Services</td><td></td><td>V</td><td></td><td>V</td></tr>
</table>

The best-execution regime seeks to address the information deficits between firms and their clients as to price formation and aims to ensure that an investor's trade is executed on the most favourable terms.[239] It imposes 'positive obligations on investment firms regardless of the terms of their contracts' with their clients.[240] Investment firms must take all 'sufficient steps' when executing orders to obtain the 'best possible result' for their clients, taking into account 'price, costs, speed, likelihood of execution and settlement, size, nature or any other considerations'.[241] The 'sufficient steps' is a standard higher than the 'reasonable steps' but lower than the 'appropriate steps'.[242]

In terms of the 'best execution', it has no precise legal definition in order to embrace 'a multitude of concerns relating to the nature of market participants'.[243] For a retail client, the best possible result shall be determined in terms of the total

239 N. Moloney, *EU Securities and Financial Markets Regulation*, above note 61, at 583–584.
240 A. Hudson, above note 149, para. 10-43.
241 Article 27.1 of MiFID II. For detailed criteria of the best execution: see Article 64 of Delegated Regulation of MiFID II.
242 Dick Frase, 'Best Execution under MiFID II' in Jonathan Herbst (ed), *A Practitioner's Guide to MiFID II* (2nd edn, Sweet & Maxwell, 2015), at 171; N. Moloney, *EU Securities and Financial Markets Regulation*, above note 61, at 521. For a further explanation: see ESMA, Questions and Answers on MiFID II and MiFIR investor protection topics, ESMA35-43-349, April, 2017, at 12–13, available at: <https://www.esma.europa.eu/sites/default/files/library/esma35-43-349_mifid_ii_qas_on_investor_protection_topics.pdf> (accessed June, 2017).
243 Jonathan R. Macey and Maureen O'Hara, 'The Law and Economics of Best Execution' (1997) 6 *Journal of Financial Intermediation* 188, at 218–219.

consideration: that is, account must be taken of not only the execution price, but also the associated costs.[244] Where there is more than one competing venue to execute an order, the firm's commissions and the costs for executing of each eligible execution venues shall also be taken into account. [245] Conflict-of-interest and inducement rules are also required between investment firms and trading venues.[246] A firm's commissions shall not differentiate unfairly between execution venues by imposing different charges for different venues that do not reflect actual differences in execution costs to the firm.[247]

The above flexible concept of 'best execution' may make competition between trading venues[248] easier, but it would also encounter some difficulties in practice.[249] Therefore, in support of this obligation, investment firms must establish and implement 'effective arrangements', including an order execution policy, to allow them to obtain the 'best possible' result.[250] Although these policies must consider different venues for the execution of such transactions and the factors affecting the choice of execution venues,[251] an investment firm's own commission or fees charged to the client must not be used for determining what execution venues should be included in the firm's execution policy.[252] Likewise, investment firms are required to provide information

244 Recital 93 and Article 27.1 of MiFID II.
245 Article 27.1 of MiFID II.
246 Articles 27.2 of MiFID II referring to Articles 16.3, 23 and 24 of MiFID II.
247 Recital 95 of MiFID II.
248 According to Article 2.1(24) of MiFID II, a trading venue means a regulated market, a multilateral trading facility ('MTF') or an organised trading facility ('OTF'). As to the definitions of MTFs and OTFs, please see Articles 2.1(22) and 2.1(23) of MiFID II.
249 For example, it is not so easy to compare the price data with those concerning speed the execution and settlement. See further in Guido A. Ferrarini, 'Best Execution and Competition Between Trading Venues - MiFID's Likely Impact' (2007) 2 *Capital Markets Law Journal* 404, at 407–408.
250 Article 27.4 of MiFID II.
251 Article 27.5.1 of MiFID II; see also Article 66 of Delegated Regulation of MiFID II.
252 Recital 94 of MiFID II.

about these policies to clients in sufficient detail and in clear, easily understandable language[253] (including whether or not execution may involve execution outside a regulated market or multilateral trading facility)[254], in order to obtain the prior consent of clients to the execution policy.[255] Firms then have to monitor the effectiveness of their execution policies, in order to identify and correct any deficiencies.[256] Clients may even request a firm to demonstrate that orders have been executed in accordance with the firm's execution policy.[257] On top of the disclosure of execution policies, a broader information requirement about the best execution are further inserted by MiFID II: (i) in order to allow the public and investment firms to assess standard statistics on execution quality, execution venues shall publish periodic reports of data relating the quality of execution of transactions;[258] (ii) similarly, in order to enable clients to assess the execution quality obtained and challenge the results obtained, investment firms will need to summarise and disclose to the public annually about the details of the main five execution venues for each of the main categories of financial instruments they provide services in relation to.[259]

In addition, pursuant to Article 28 of MiFID II, investment firms are required to ensure that orders executed on behalf of clients are conducted by reference to 'procedures and arrangements' which 'provide for the prompt, fair and expeditious

[253] Article 27.5.2 of MiFID II; see also Article 66 of Delegated Regulation of MiFID II.
[254] Article 27.5.3 of MiFID II; see also Article 66 of Delegated Regulation of MiFID II.
[255] In fact, the need for the disclosure of execution policies remains questionable. Professor Moloney claims this disclosure plus consent regime may place an enormus burden on retail investors: see N. Moloney, 'Large-Scale Reform of Investor Protection Regulation: The European Union Experience', above note 166, at 164.
[256] Article 27.7 of MiFID II; see also Article 66 of Delegated Regulation of MiFID II.
[257] Article 27.8 of MiFID II.
[258] Recital 96 and Article 27.3 of MiFID II.
[259] Recital 97 and Article 27.6 of MiFID II.

execution of client orders',[260] and they have to follow a time-priority rule to execute otherwise comparable client orders in accordance with the time of their reception.[261] This provision particularly aims at tackling conflicts that can arise between the interests of several clients using the same investment services from the investment firm, because, in some cases, the best interest of one client may be at the expense of other clients' best interests—'a duty of loyalty now is transformed into a duty of equal treatment'.[262] To some extent, this article, together with the foregoing best-execution requirement, forms a wider order-execution regime.

3.3.8. Product Requirement

In the past, financial products were regulated principally on the basis of the identity of the issuer, rather than the nature of the product, so there is a lack of basic safety rules on financial products when consumers are using them.[263] Despite the successful experience of the UCITS Directive,[264] the product-oriented rules[265] had been ignored for some time.[266] However, in the wake of behavioural economics, the rules of investment conduct are changing track from the 'line of rational expectations investor

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[260] Article 28.1 of MiFID II; see further in Articles 67–70 of Delegated Regulation of MiFID II.
[261] Article 28.2 of MiFID II; see further in Articles 67–70 of Delegated Regulation of MiFID II.
[262] M. Kruithof, 'Conflicts of Interest in Institutional Asset Management: Is the EU Regulatory Approach Adequate?', above note 198, at 317.
[263] Elizabeth Warren, 'Product Safety Regulation as a Model for Financial Services Regulation' (2008) 42 *Journal of Consumer Affairs* 452, at 457–459.
[264] Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), 1985 OJ L375/3. ('UCITS I')
[265] In fact, the distinction between the process-oriented and the product-oriented rules was introduced in the field of the genetically modified food regulation in 2000: see Claire Dunlop, 'GMOs and Regulatory Styles' (2000) 9 *Environmental Politics* 149, at 149–154.
[266] For example, MiFID I only contains two relevant provisions of product requirements conferring NCAs powers to (i) suspend trading in a financial instrument in Article 50.2(j), and (ii) remove a financial instrument from trading in Article 50.2(k).

model' to the 'line of trusting investor model'.[267] This means investors are not as sophisticated as expected, and more interventionist rules might be better to protect investors' trust on the system.[268] This is a legitimate and important reason calling for stronger paternalism.[269] The introduction of product requirements into MiFID II represents the most powerful and interventionist form of retail market regulation to compensate the shortcomings of the aforementioned other requirements.[270]

Specifically, the product-oriented rules have three focuses: (i) pre-contractual and marketing information obligations, (ii) *ex ante* product governance arrangements; and (iii) *ex post* product intervention.[271] Relevant rules tackling these three focuses are introduced in the MiFID II package. The first focus has been discussed above.[272] In terms of the second focus, the product governance arrangement is introduced in MiFID II. As one of the responsibilities of the management body, it shall define, approve and oversee a policy as to such products in accordance with 'the risk tolerance of the firm' and 'the characteristics and needs of their clients'.[273] Investment firms which manufacture financial instruments for sale to clients will be required to maintain a product approval process that must identify the target market for each product and

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[267] Lynn A. Stout, 'The Investor Confidence Game' (2002) 68 *Brooklyn Law Review* 407, at 410–420.
[268] For further discussion regarding interventionist approaches: see Akinbami Folarin, 'Financial Services and Consumer Protection After the Crisis' (2011) 29 *International Journal of Bank Marketing* 134, at 136–139.
[269] Anthony I. Ogus, 'Regulatory Paternalism: When is it Justified?' in Klaus J. Hopt et al (eds), *Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan, and the US* (Oxford University Press, 2005), at 317–319.
[270] Niamh Moloney, 'Regulating the Retail Markets' in Niamh Moloney, Eilís Ferran and Jennifer Payne (eds), *The Oxford Handbook on Financial Regulation* (Oxford University Press, 2015), at 761–764.
[271] Gaetane Schaeken Willemaers, 'Client Protection on European Financial Markets – From Inform Your Client to Know Your Product and Beyond: An Assessment of the PRIIPs Regulation, MiFID II/MiFIR and IMD 2' (2014) 3 *Revue Trimestrielle de Droit Financier/ Corporate Finance and Capital Markets Law Review* 143, at 143–144.
[272] See Section 3.3.3 above (pp. 38–39).
[273] Article 9.3(b) of MiFID II.

ensure that 'all relevant risks to such identified market are assessed and that the intended distribution strategy is consistent with the identified target market'.[274] The target market and performance of products should be subject to regular reviews.[275] Investment firms which offer or recommend financial instruments must ensure that they understand the features of those products, including the 'identified target market'.[276] Given this, product manufacturers and distributors all should know their products. This regulatory policy is away from the POS regulation and concentrates much more on product design and distribution, as 'a sensible response to the risks posed by financial innovation'.[277] NCAs are empowered to 'suspend the marketing or sale of financial instruments or structured deposits' where the firm does not meet the above requirements.[278] It should be noted that these provisions do not define duties on the part of investment firms clearly, so practical difficulties may emerge in the near future.[279]

With regard to the third focus of the product-oriented rules, the power of product intervention is embedded in MiFIR and the KID Regulation, as a rudimentary shift to 'post market control'.[280] According to Articles 40–42 of MiFIR, ESMA, EBA and NCAs are given powers to impose temporary, or (in the case of NCAs) permanent, prohibitions or restrictions, on the marketing, distribution or sale of (in the case of

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[274] Article 16.3.3 of MiFID II; see also Recital 71 of MiFID II. For the detailed requirements: see Article 9 of Delegated Directive of MiFID II.
[275] Article 16.3.4 of MiFID II.
[276] Article 16.3.6 of MiFID II. For the detailed requirements: see Article 10 of Delegated Directive of MiFID II.
[277] Iain MacNeil, 'Product Regulation and Governance' (2013) 7 *Law and Financial Markets Review* 135, at 135.
[278] Article 69.2(t) of MiFID II.
[279] Yane Svetiev and Annetje Ottow, 'Financial Supervision in the Interstices Between Private and Public Law' (2014) 10 *European Review of Contract Law* 496, at 502.
[280] Hans-Wolfgang Micklitz, 'The Public and the Private – European Regulatory Private Law and Financial Services' (2014) 10 *European Review of Contract Law* 473, at 473.

ESMA and NCAs) certain financial instruments, or on financial activities or (in the case of EBA and NCAs) certain structured deposits where there is 'a significant investor protection concern' or a 'threat to the orderly functioning and integrity of the financial or commodity markets', or 'the stability of the whole or part of the financial system'.[281] These powers will be available on a precautionary basis even before the financial instrument has been marketed to clients,[282] but the prohibition or restrictions made by NCAs must be removed when the conditions no longer apply.[283] When powers are exercised by NCAs, they are required to notify ESAs and other relative NCAs in advance.[284] In exceptional cases where urgent action is necessary, NCAs can 'take action on a provisional basis with no less than 24 hours' written notice'.[285] When complementary powers are exercised by ESMA or EBA, more restrictive elements shall be met[286] with a notice before taking any action.[287] The KID Regulation also gives EIOPA and NCAs similar product intervention powers to impose a ban or restriction on 'the marketing, distribution or sale' of particular insurance-based investment products, or on 'financial activity or practice' of an insurance or reinsurance undertaking.[288] In practice, this extends the product intervention powers in MiFIR to any PRIIPs that would not otherwise fall under the ambit of MiFIR. All of these provisions of product intervention become a potentially powerful tool available to ESAs

[281] For detailed criteria and factors that have to be taken into account when enforcing the product intervention powers: see Article 19–21 of Delegated Regulation of MiFIR.
[282] Articles 40.2, 41.2 and 42.2 of MiFIR.
[283] Article 42.6 of MiFIR.
[284] Article 42.3 of MiFIR.
[285] Article 42.4 of MiFIR.
[286] For ESMA: see Articles 40.2 and 40.3 of MiFIR; for EBA: see Articles 41.2 and 41.3 of MiFIR.
[287] For ESMA: see Articles 40.4 and 40.5 of MiFIR; for EBA: see Articles 41.4 and 41.5 of MiFIR.
[288] Articles 16 and 17 of KID Regulation.

and NCAs, showing a trend towards 'hard paternalism'[289] or 'consumerisation'[290].

Having said that, the introduction of product requirements is not without concerns. The first question is whether the product-oriented rules could fit conceptually into the current regulatory system which is, obviously, non-product-oriented.[291] In particular, it sometimes can be difficult to distinguish issues relating to the quality of investment services from those relating to the quality of financial products.[292] It may need more cases in practice to clarify this. Second, underlying these tighter controls is the premise that financial innovation may introduce new forms of risk into the financial system,[293] but such bans would also stifle the advantages of competition and innovation in financial markets.[294] For example, automation in investment advice enables clients to enjoy services in a potentially beneficial way in terms of costs, access, and quality of service, because automated tools are faster, more consistent, accessible, up-to-date, wide-ranging, and need less human resources.[295] Third, product requirements may

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289 O. Cherednychenko Olha, 'Freedom of Contract in the Post-Crisis Era: Quo Vadis?' (2014) 10 *European Review of Contract Law* 390, at 398–401.

290 Niamh Moloney, 'The Investor Model Underlying the EU's Investor Protection Regime: Consumers or Investors?' (2012) 13 *European Business Organization Law Review* 169, at 172–179.

291 I. MacNeil, above note 277, at 135.

292 Gerard McMeel and John Virgo, *McMeel and Virgo on Financial Advice and Financial Products* (3rd edn, Oxford University Press, 2014), paras. 1.74–1.75.

293 Iain G. MacNeil, *An Introduction to the Law on Financial Investment* (2nd edn, Hart Publishing, 2012), at 216. The Commission also admits the benefits of financial innovation for investors, in particular which caused by the FinTech reform: see European Commission, Public Consultation on The Capital Markets Union Mid-Term Review, January, 2017), at 14, available at: <https://ec.europa.eu/info/sites/info/files/consultation-document_en_0.pdf> (accessed June, 2017).

294 Helen A. Garten, 'The Consumerization of Financial Regulation' (1999) 77 *Washington University Law Review* 287, at 307–314; Geraint Howells, 'The Potential and Limits of Consumer Empowerment by Information' (2005) 32 *Journal of Law & Society* 349, at 366–367; O. Cherednychenko Olha, above note 289, at 418–419. For further discussion about the 'benefit' side of financial innovation: see Emilios Avgouleas, 'Regulating Financial Innovation: A Multifaceted Challenge to Financial Stability, Consumer Protection, and Growth' in Niamh Moloney, Eilís Ferran and Jennifer Payne (eds), *The Oxford Handbook on Financial Regulation* (Oxford University Press, 2015), at 667–668 and 683–687.

295 Joint Committee of the ESAs, Joint Committee Discussion Paper on automation in financial advice, JC 2015 080, December, 2015, paras. 7 and 31–39, available at: <https://www.eba.europa.eu/documents/10180/1299866/JC+2015+080+Discussion+Paper+on+automation+in+financial+advice.pdf> (accessed June, 2017).

further raise some concerns about second-guessing weakness of supervisors, the risk-taking of retail investors and the elusion of governing concepts.[296] There is also a risk that supervisors might be very 'passive' once they have only little experience in this area.[297] In the light of these concerns, bans on products shall be the 'last resort' and need strong justification.

4. Challenges of Current System

4.1. Institutional Tension between EU Institutions, ESMA and Member States

Although the multi-level rule-making system established by the Lamfalussy process and the de Larosière reforms enhances the efficiency of harmonisation of investment conduct rules in the EU,[298] it also causes some institutional tension between European institutions, ESMA and Member States, particularly in relation to the process of making Level 2 legislation.

In terms of 'Commission-only' Level 2 acts with ESAs' support, the divide of delegated acts and implementing acts might be contestable.[299] Because the CJEU simply explains that 'the concept of an implementing act within the meaning of Article 291 TFEU must be assessed in relation to the concept of a delegated act, as derived from

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296 N. Moloney, *EU Securities and Financial Markets Regulation*, above note 61, at 833–835.

297 Olha O. Cherednychenko, 'Cooperative or Competitive? Private Regulators and Public Supervisors in the Post-Crisis European Financial Services Landscape' (2016) 35 *Policy and Society* 103, at 113.

298 See Sections 3.1 and 3.2 above (pp. 23–32).

299 For example, Paul Craig, 'Delegated Acts, Implementing Acts and the New Comitology Regulation' (2011) 36 *European Law Review* 671, at 672–678; Joana Mendes, 'Delegated and Implementing Rule Making: Proceduralisation and Constitutional Design' (2013) 19 *European Law Journal* 22, at 22–41; Merijn Chamon, 'Clarifying the Divide between Delegated and Implementing Act?' (2015) 42 *Legal Issues of Economic Integration* 175, at 184–189; Dominique Ritleng, 'The Dividing Line between Delegated and Implementing Acts: The Court of Justice Sidesteps the Difficulty in Commission v. Parliament and Council (Biocides)' (2015) 52 *Common Market Law Review* 243, at 251–254.

Article 290 TFEU'[300] and leaves as much flexibility as possible to the political institutions,[301] Member States may always claim that the EU's legislators pick a wrong type of Level 2 rules, as a strategy to fight their own sovereignty. In order to end this annoying fight, the CJEU further confirms that legislature should enjoy full discretion in choosing between these two types of acts once it could fulfill the conditions set by the Treaty articles,[302] so the line is set down by 'the intention of the EU legislature'.[303] However, this clarification may no be able to end the political fight within the EU legislative system with regard to the choice between delegated acts and implementing acts.[304]

Moreover, given that ESMA only plays an advisory and non-binding role in the rule-making process of delegated and implementing acts, the Commission might choose to assert itself regardless of ESMA's advice. As pointed out by some scholars, in the early days of the Lamfalussy process, the Commission redrafted CESR's initial advice on Level 2 measures many times.[305] There might be a conflict between technical concerns of ESMA and political considerations of the Commission. To an extreme extent, the Commission may consider ESMA as a rival to its rule-making powers, causing a fight that renders the rule-making process slow, ineffective and inefficient.[306]

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300 CJEU, Case C-427/12, *Commission v Parliament and Council*, [2014] ECLI:EU:C:2014:170, para. 35.
301 Ibid, para. 40
302 CJEU, Case C-88/14, *Commission v Parliament and Council*, [2015] ECLI:EU:C:2015:499, paras. 28–30.
303 Ibid, para. 43.
304 Due to the focus of this study and the limited space, it is unable to provide comprehensive discussion here. For a detailed analysis regarding the post-Lisbon legislative tension in Articles 290 and 291 of the TFEU: see Carl Fredrik Bergström and Dominique Ritleng (eds), *Rulemaking by the European Commission: The New System for Delegation of Powers* (Oxford University Press 2016).
305 Niamh Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' (2010) 47 *Common Market Law Review* 1317, at 1353.
306 Madalina Busuioc, 'Rule-Making by the European Financial Supervisory Authorities: Walking a Tight Rope' (2013) 19 *European Law Journal* 111, at 122–123.

In the matter of Level 2 technical standards made by 'ESAs plus the Commission', institutional tension might be even greater. This is because the constitutionality of ESMA's powers in making technical standards might still be challengeable.[307] Specifically, ESMA enjoys the sole power to initiate drafting of technical standards, because only ESMA, subject to prior public consultations and cost-benefit analysis requirements, could submit a draft to the Commission.[308] Once the draft is submitted, the Commission only could decide not to endorse it, or endorse it in part, or with amendments.[309] Only if it was incompatible with EU law and Treaty principles,[310] the Commission could send back the draft to ESMA and explain the reasons for doing so.[311] If ESMA then does not submit an amended draft within a six-week period, or submit one that is not amended in line with the Commission's proposed amendments, the Commission then can adopt the technical standard with the amendments it wants.[312] Obviously, the Commission is severely restricted in its constitutional powers to participate the rule-making process of Level 2 technical standards. There is a risk that the Commission would simply be a 'rubber stamp' to ESMA.[313] Furthermore, the line between pure technical standards and those involving policy choices will not be clear-cut in practice.[314] The separation between RTSs and ITSs is not easy to make in

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307 Herwig C. H. Hofmann, 'Seven Challenges for EU Administrative Law' (2009) 2 *Review of European Administrative Law* 37, at 46–48; Merijn Chamon, 'EU Agencies between Meroni and Romano or the Devil and the Deep Blue Sea' (2011) 48 *Common Market Law Review* 1055, Sec. 4.1.

308 Articles 10.1 and 15.1 of ESMA Regulation.

309 Ibid.

310 Recital 23 of ESMA Regulation.

311 Articles 10.1 and 15.1 of ESMA Regulation.

312 Articles 10.1(7) and 15.1(7) of ESMA Regulation.

313 Gianni Lo Schiavo and Alexander Türk, 'The Institutional Architecture of EU Financial Regulation: The Case of the European Supervisory Authorities in the Aftermath of the European Crisis' in Leila Simona Talani (ed), *Europe in Crisis: A Structural Analysis* (Palgrave Macmillan UK, 2016), at 107–108, 115; M. Busuioc, above note 306, at 123.

314 Niamh Moloney, 'The European Securities and Markets Authority and Institutional Design for the

practice either.[315] ESMA is very likely to become a pre-decision-making agency with *de facto* decision-making powers on policy choices.[316] Technical standards, thus, give rise to the question regarding democratic legitimacy of this type of executive legislation by the independent ESMA.[317]

Furthermore, since (i) the Parliament and the Council may object to RTSs adopted by the Commission,[318] and (ii) they may invite the responsible Commissioner, together with the chairperson of ESMA, to present and explain their differences in the event that the Commission does not endorse an RTS or amends it,[319] ESMA might become an 'institutional battleground' of European institutions, leading to fraught rule making.[320] For example, some part of the drafted technical standards of MiFID II were rejected by the Parliament in March, 2016, and the Commission sent letters to ESMA requiring appropriate amendments, but ESMA wondered how to react to such letters and start

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EU Financial Market – A Tale of Two Competences: Part (1) Rule- Making' (2011) 12 *European Business Organization Law Review* 41, at 68; Dorothee Fischer-Appelt, 'The European Securities and Markets Authority: The Beginnings of a Powerful European Securities Authority' (2011) 5 *Law and Financial Markets Review* 21, at 25; Takis Tridimas, 'EU Financial Regulation: Federalization, Crisis Management, and Law Reform' in Paul Craig and Gráinne de Búrca (eds), *The Evolution of EU Law* (Oxford University Press, 2011), at 802; Nicolette Kost de Sevres and Lorenzo Sasso, 'The New European Financial Markets Legal Framework: A Real Improvement? An Analysis of Financial Law and Governance in European Capital Markets from A Micro- and Macro-Economic Perspective' (2012) 7 *Capital Markets Law Journal* 30, at 49; Gudula Deipenbrock, 'The European Securities and Markets Authority and Its Regulatory Mission: A Plea for Steering a Middle Course' in Mads Andenas and Gudula Deipenbrock (eds), *Regulating and Supervising European Financial Markets: More Risks than Achievements* (Springer, 2016), at 32; G. Tsagas, above note 60, at 133.

315 G. Deipenbrock, ibid, at 22.

316 G. L. Schiavo and A. Türk, above note 313, at 103; Stefan Griller and Andreas Orator, 'Everything under Control? The "Way Forward" for European Agencies in the Footsteps of the Meroni Doctrine' (2010) 35 *European Law Review* 3, at 14.

317 F. Walla, 'Capital Markets Supervision in Europe', in Rüdiger Veil (ed), European Capital Markets Law (Hart Publishing, 2013) in Rüdiger Veil (ed), European Capital Markets Law (Hart Publishing, 2013), at 121. See further in Section 4.2 of CHAPTER III (pp. 117–121).

318 Article 13.1 of ESMA Regulation.

319 Article 14.1 of ESMA Regulation.

320 N. Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (1) Rule- Making', above note 314, at 75–78.

the required amendments.[321] In this sense, in order to find a fine balance within this multi-level rule-making system, how to divide tasks between ESMA and the Commission will be of crucial importance in the future practice.[322]

4.2. Limited Function of A Single Rulebook

As discussed above,[323] rules of investment conduct are harmonised to a large extent with an aim to establish a Single Rulebook in the EU. The establishment of this Single Rulebook could be achieved by two ways. First, by means of enacting more 'rule-based' legislation at Level 1, Member States will have little space to implement it. For example, on the basis of an examination of divergences and weaknesses of national sanctioning regimes conducted by the Commission after the financial crisis,[324] more 'rule-based' legislation regarding administrative powers of NCAs was introduced in MiFID II.[325] Article 70 of MiFID II ensures NCAs may be able to impose

321 For the letters sent by ESMA to the Commission: see
<https://www.esma.europa.eu/system/files_force/library/2016-404_letter_eu_comm_guersant_-_non-equity_transparency.pdf>
<https://www.esma.europa.eu/system/files_force/library/2016-403_letter_eu_comm_guersant_-_ancillary_activity.pdf>
<https://www.esma.europa.eu/system/files_force/library/2016-402_letter_eu_comm_guersant_-_position_limits.pdf> (accessed June, 2017).
For the Commission's response to these letters: see
<http://ec.europa.eu/finance/securities/docs/isd/mifid/160420-letter-to-esma-rts-02_en.pdf>
<http://ec.europa.eu/finance/securities/docs/isd/mifid/160420-letter-to-esma-rts-20_en.pdf>
<http://ec.europa.eu/finance/securities/docs/isd/mifid/160420-letter-to-esma-rts-21_en.pdf>
(accessed June, 2017).

322 For an up-to-date table listing varied Level 2 rules of EU legislation in the area of financial services, available at:
<http://ec.europa.eu/finance/general-policy/docs/level-2-measures/level2-measures_en.pdf> (accessed June, 2017).

323 See Section 3.3 above (pp. 32–61).

324 See European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Reinforcing sanctioning regimes in the financial services sector, COM(2010) 716 final, December, 2010, at 6–10, available at:
<http://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2010/com_2010_0716_en.pdf>
(accessed June, 2017).

325 See, e.g., Articles 69–73 of MiFID II.

'administrative sanctions' and measures applicable to all infringements of MiFID II and MiFIR and relative legislation, and shall take all measures necessary to ensure that they are implemented. This Article further lists substantive provisions that relate to investment conduct, including those on the management and internal policies of firms (Article 9.3),[326] the governance of the product development process (Articles 16.2, 16.3 and 16.5)[327] as well as the provisions to ensure investor protection (Section 2).[328] Then this Article specifies the kinds of administrative remedies to be made available to NCAs, ranging from the naming and shaming of violators (Article 70.6(a)), the imposition of cease and desist orders (Article 70.6(b)), the withdrawal of authorisation and banning individuals from performing management functions (Articles 70.6(c)–(e)), to the significant administrative fines for both institutions and individuals (Articles 70.6(f)–(h))[329]. This reform not only reveals the essentially administrative nature of MiFID II, but also ensures consistency in relation to the application of sanctions across the EU.[330] By listing administrative tools and sanctioning powers in detail at Level 1 legislation, a common minimum set is established to pave the way towards an equivalent intensity of enforcement across the integrated financial market.[331] Second, even extremely 'rule-based' legislation might not be in place at Level 1 entirely, a similar effect could be attained at Level 2 rules. In the current 'hub-and-spoke'[332] rule-making system: the 'hub'

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326 Article 70.3(a)(ii) of MiFID II.
327 Article 70.3(a)(iv) of MiFID II.
328 Article 70.3(a)(x)–(xvi) of MiFID II.
329 Maximum administrative fines of at least 5 million euro and up to 10 % of the total annual turnover of a legal person or twice the amount of the benefit derived from the infringement.
330 Arun Srivastava, 'Conduct of Business Standards: Fair Dealing with Clients' in Jonathan Herbst (ed), *A Practitioner's Guide to MiFID II* (2nd edn, Sweet & Maxwell, 2015), at 127.
331 Recital 137 of MiFID II.
332 European Commission, Financial Supervision Package - Frequently Asked Questions, MEMO/10/434, September, 2010, Question 12, available at:

(ESMA) would elaborate detailed rules and recommendations to the 'spokes' (NCAs). Ideally, the rules issued by the 'hub' could also narrow the permissible scope for the addition of supplementary local rules that are more stringent and squeeze local discretion of 'spokes'.[333]

However, while MiFID II specifies a minimum set of powers that NCAs should have, these powers are still exercised by NCAs within the national laws.[334] NCAs still have choices to 'gold-plate' them, so the harmonisation has its limits for achieving uniformity to European capital markets law.[335] Also, even a Level 2 function of the Lamfalussy process has significantly contributed to the development of a flexible, efficient and inclusive decision-making process in harmonising European rules, if the implementation and enforcement of these rules are left to Member States, they still would be 'likely to reflect national demands, which could vary across Member States'.[336] Even the rule-making system is getting more 'Europeanised', national divergences in implementation, interpretation and application of the EU law must remain.[337] This is an intrinsic limit of the Single Rulebook. As admitted by the de Larosière report[338] and the

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<http://europa.eu/rapid/press-release_MEMO-10-434_en.pdf> (accessed June, 2017).

333 E. Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision', above note 78, at 140–141.

334 Recital 138 of MiFD II.

335 Luca Enriques and Matteo Gatti, 'Is There a Uniform EU Securities Law after the Financial Services Action Plan' (2008) 14 *Stanford Journal of Law, Business & Finance* 43, at 78–80.

336 Iris H.-Y. Chiu, 'Three Challenges Ahead for the New EU Securities Regulation Directives' (2006) 17 *European Business Law Review* 121, at 129.

337 Jan Smits, 'A Principled Approach to European Contract Law?' (2000) 7 *Maastricht Journal of European and Comparative Law* 221, at 221–223; Stephen Weatherill, 'Pre-emption, Harmonisation and the Distribution of Competence to Regulate the Internal Market' in Catherine Barnard and Joanne Scott (eds), *The Law of the Single European Market: Unpacking the Premises* (Hart publishing, 2002), at 68–69; D. Vitkova, 'Level 3 of the Lamfalussy Process: An Effective Tool for Achieving Pan-European Regulatory Consistency?' (2008) 2 *Law and Financial Markets Review* 158, at 170.

338 The de Larosière report, above note 77, para. 160.

Lamfalussy review,[339] the Single Rulebook might be of little help in strengthening the supervisory co-operation and convergence between NCAs. Both the Green Paper[340] and the Action Plan of CMU[341] recognise the limited function of the Single Rulebook, and further admit that fostering great supervisory convergence might be a better way to tackle this issue.[342]

4.3. Unclear Influence on Private Law

The MiFID regime, at the first glance, only recognises that investment services are provided on a contractual basis by requiring an investment firm to establish a documentary record regarding the contractual terms,[343] and does not mandate any specific contents of such a contract. This is because many private law duties now are coined as administrative standards (such as, the 'conflict-of-interest'[344] and 'suitability'[345] requirements) checked by NCAs and their staff, rather than courts.[346] However, albeit these rules applicable to investment firms are regulatory rules now, their relevance to

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339 See European Commission, Communication from the Commission- Review of the Lamfalussy Process: Strengthening Supervisory Convergence, COM(2007) 727 final, November, 2007, at 6–13, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52007DC0727&from=EN> (accessed June, 2017).

340 European Commission, Green Paper: Building a Capital Markets Union, COM(2015) 63 final, February, 2015, at 22, available at: <http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf> (accessed June, 2017). ('Green Paper of CMU')

341 European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Action Plan on Building a Capital Markets Union, COM(2015) 468 final, September, 2015, at 24, available at: <http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf> (accessed June, 2017). ('Action Plan of CMU')

342 European Commission, Green Paper of CMU, above note 340, at 22; European Commission, Action Plan of CMU, ibid, at 26. See further discussion regarding divergent supervisory cultures in Section 4.3 of CHAPTER III (pp. 121–128).

343 Article 25.5 of MiFID II.

344 See further in Section 3.3.5 above (pp. 43–48).

345 See further in Section 3.3.6 above (pp. 48–50).

346 Stefan Grundmann, 'EC Financial Services–Developments 2002–2005' (2005) 1 *European Review of Contract Law* 482, at 490–491; see also Articles 67.2 and 70 of MiFID II.

private law still remains.[347] One distinctive characteristic of the rules of investment conduct is they 'usually create both regulatory (public law) and contractual-tortious (private law) obligations'.[348] Given this characteristic, investment conduct rules within the MiFID regime intrinsically determines the contents of the legal relationship between the client and the investment firm to a large degree, causing a partial 'eclipse' of normal contract law.[349] Even if the 'eclipse' is an overstatement, the provisions of the MiFID Regime indeed bring significant influence on private law systems. First, agreements made between investors and investment firms must set out the 'rights and obligation between the parties', complying with the general requirement applicable in the MiFID regime.[350] Although there is no further guidance regarding what 'rights and obligations of the firm and the client' in agreements are, the essential terms of retail agreements typically are required to cover all the requirements mentioned above in Section 3.3.[351] Second, decisions of the 'suitability'[352] and 'appropriateness'[353] requirements are based on information required by relative terms of contract. Given NCAs are vested with powers to examine these decisions,[354] contractual terms, inevitably, would be influenced by the attitudes of NCAs. Finally, such obligations in the MiFID regime are considered

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347 Michel Tison, 'Conduct of Business Rules and Their Implementation in the EU Member States' in Guido Ferrarini, Klaus J. Hopt and Eddy Wymeersch (eds), *Capital Markets in the Age of the Euro: Cross-Border Transactions, Listed Companies and Regulation* (Kluwer Law International, 2002), at 76.

348 E. Avgouleas, above note 50, at 74.

349 Peter O. Mülbert, 'The Eclipse of Contract Law in the Investment Firm-Client-Relationship: The Impact of the MiFID on the Law of Contract from a German Perspective' in Guido Ferrarini and E. Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond* (Oxford University Press, 2006), at 316–320.

350 Article 25.5 of MiFID II.

351 Philip R. Wood, *Regulation of International Finance* (2nd edn, Sweet & Maxwell, 2007), para. 14-010.

352 See further in Section 3.3.6 above (pp. 48–50).

353 See further in Section 3.3.6 above (pp. 50–51).

354 Articles 69 and 70 of MiFID II.

by courts in defining the investment firms' duties under private law.[355] Member States shall also ensure that specific bodies may be able to, 'in the interests of consumers and in accordance with national law', take action before courts to ensure that MiFIR and MiFID II are applied in Member States.[356]

However, the MiFID regime provides no harmonised civil liability system regarding these obligations, and leaves Member States at liberty to make their own arrangements. The KID Regulation might be the only legislation tackling this issue explicitly: in order to protect retail investors from misleading, inaccurate or inconsistent with the relevant parts of the contractual documents of PRIIPs, KID Regulation harmonises rules regarding the civil liability of PRIIPs manufacturers.[357] In the absence of a similar provision within MiFID II/MiFIR, the interaction between regulatory rules of investment conduct and national private laws is still open to debate. This method could be unsatisfactory and disparate, causing the MiFID regime to become a '*lex imperfecta*'.[358] Furthermore, the situation might be even more complicated if you take into account the role of ESMA. For instance, what effect ESMA's technical standards will have on the enforcement under private law,[359] and what impact of ESMA's non-binding guidelines and recommendations will have on market participants in individual private cases.[360] In fact, the Action Plan of CMU acknowledges such

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355 G. Ferrarini, above note 186, at 22.
356 Article 74.2 of MiFID II.
357 Recital 22 and Article 11 of KID Regulation.
358 L. Enriques and M. Gatti, above note 335, at 76–77; Ünal Tekinalp, 'Investor Protection and Investment Firms' Duty of Care and Loyalty to Clients' in Stefan Grundmann and Yesim M. Atamer (eds), *Financial Services, Financial Crisis and General European Contract Law: Failure and Challenges of Contracting* (Kluwer Law International, 2011), at 171–172 and 177; Vassilios Tountopoulos, 'Investor Protection under MiFID: A Survey of Greek Case Law' (2016) 27 *European Business Law Review* 513, at 533.
359 F. Walla, 'Capital Markets Supervision in Europe', above note 317, at 121.
360 Federico Della Negra, 'The Effects of the ESMA's Powers on Domestic Contract Law' in Mads

different national measures in private law could not be addressed by the tools of either the Single Rulebook or supervisory convergence.[361] The Green Paper of CMU also admits that securities law still differs across Member States since it touches on national private law and private international law.[362] Within these areas, due to the principles of subsidiarity[363] and proportionality[364], the EU may only be able to apply comparatively softer policies (such as, setting up a network of Member States and engaging in bilateral discussions).[365]

5. Concluding Remarks

This chapter has explored the extant rule-making system and harmonised rules of investment conduct in the EU. It started with the internal market and the Single Passport regime in relation to investment intermediaries in the EU. Due to the fact that regulatory competition and the home country control may not be able to function orderly, harmonisation of rules is necessary in the EU. This chapter then graduated into a concise discussion of the multi-level ruling-making system established by the Lamfalussy process and the de Larosière reforms. It delineated that this ruling-making system, which shows a massive shift of the rule-making role to ESMA from NCAs, has significantly contributed to the development of a flexible, efficient and inclusive decision-making process in harmonising European rules. Also, given the example of the

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Andenas and G. Diepenbrock (eds), *Regulating and Supervising European Financial Markets: More Risks than Achievements* (Springer, 2016), at 156–159.

361 European Commission, Action Plan of CMU, above note 341, at 24.

362 European Commission, Green Paper of CMU, above note 340, at 23.

363 Article 5.3 of the TEU.

364 Article 5.4 of the TEU.

365 See further discussion in Section 2.2 (pp. 197–199) and Section 3.4 (pp. 211–212) of CHAPTER V.

densely and exhaustively harmonised rules of investment conduct in the MiFID II package, a movement towards an overarching harmonised Single Rulebook framework is on the way to lay down a 'level playing field' of Member States in the European capital markets.

However, the competence allocation of the current system may face some challenges. First, the multi-level rule-making process causes some institutional tension between European institutions, ESMA and Member States, particularly in making Level 2 legislation. Second, the Single Rulebook has its limits. It is impossible to write down everything in detail. Implementation, interpretation, application and enforcement of the Single Rulebook play an equally important role in practice. Therefore, in cross-border transactions, even though the rules of investment conduct are harmonised to a large extent in the EU, supervisory issues still matter to investment firms and their clients. Last but not least, the relationship between such harmonised rules of investment conduct and private law systems remains unclear at the current stage, but it is undeniable that the MiFID regime affects private relationships between investment firms and their clients to some extent. In the light of this, the plan of CMU provides a valuable policy implication: it not only highlights the importance of private law systems of European capital markets, but also catches attention to the Treaty limitations of the EU's powers.

CHAPTER III

COMPETENCE ALLOCATION OF INVESTMENT CONDUCT REGULATION IN THE EU—SUPERVISORY SYSTEM

> *'Cross-border economic integration and national political sovereignty have increasingly come into conflict, leading to a growing mismatch between the economic and political structures of the world. The effective domains of economic markets have come to coincide less and less with national governmental jurisdictions.'*[1]

1. Introduction

As summarised in the last chapter, even though the rules of investment conduct are harmonised to a large extent in the EU, supervisory issues of investment conduct regulation still matter to investment firms and their clients in relation to cross-border transactions. This chapter, thus, is going to examine the competence allocation of supervision of investment conduct in the EU. Initially, the home country control, as one of the indispensible factors of the Single Passport regime,[2] played the major role in supervising investment conduct in the EU. However, in the wake of the global financial crisis of 2007–09, the Economic and Financial Committee ('EFC'), which is a committee of the European Union set up under Article 134 of the TFEU to promote policy co-ordination among the Member States, found that the allocation of supervisory competence between home Member States and host Member States was not so clear

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[1] R. Herring and R.E. Litan, *Financial Regulation in the Global Economy* (Brookings Institution, 1995), at xxi.
[2] See further in Section 2.2 of CHAPTER II (pp. 19–20).

and inconsistencies between Member States' supervisory powers are significant.[3] Therefore, the de Larosière Report suggested an establishment of ESAs with stronger powers to replace the old 3L3 committees.[4] Since 1 January, 2011, ESMA has been in place to take on some of the responsibilities of capital markets supervision in the EU.[5] Due to the coexistence of the home country control and ESMA, the competence allocation of investment conduct supervision is now multi-level and complicated. How the current system works and what challenges it might face are two important questions. In order to answer these two questions, this chapter will explore the incomplete home country control and the supervisory powers of ESMA, with particular emphasis on investment conduct supervision in cross-border transactions. A further aim of this exploration is to build a connection between the challenges faced by the current system of investment conduct supervision and the emergence of the idea of a single supervisor.

The text below is in four sections. Section 2 examines the practice of the home country control of investment conduct supervision in the European internal market, pointing out the tension between home and host Member States in the EU. Section 3 explores the supranational supervisory system in the EU. It highlights that investment conduct supervision in the EU not only relates to the relationship between NCAs, but also concerns the interaction between ESMA and NCAs. Challenges of the current

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[3] EFC, High Level Working Group on Cross-Border Financial Supervision Arrangements, Lessons from the Crisis for European Financial Stability Arrangements (2009), at 10–14.

[4] European Commission, Report of the High-Level Group on Financial Supervision in the EU, February, 2009, rec. 22, available at:
<http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf>
(accessed June, 2017). ('de Larosière report')
See further in Section 3.2 of CHAPTER II (pp. 27–28).

[5] Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC, 2010 OJ L331/84. ('ESMA Regulation')

system are then analysed in Section 4, along with relevant CMU's policies purposing to deal with these challenges. Finally, Section 5 draws conclusion based on the findings of the present discussion.

2. Incomplete Home Country Control of Investment Conduct Supervision in the EU

2.1. Role of Home/Host Member States in Different Business Models

Before going into any further analysis, it is important to emphasise that the home country control does not apply to every type of transnational investment services in the EU. In practice, transnational investment services could be provided by three methods in a supranational market: (i) cross-border services, (ii) subsidiaries and (iii) branches.[6] An investment firm may consider many factors (such as, the regulatory environment, tax rates, and degrees of penetration in a foreign market) to decide a most suitable method.[7] Depending on different methods, home Member States[8] and host Member States[9] also have different roles in supervising investment services. First, investment

[6] Sydney J. Key and Hal S. Scott, *International Trade in Banking Services: A Conceptual Framework* (Group of Thirty: Occasional papers 35, 1991), at 4–5.

[7] For relevant analyses in banking sector: see, e.g., Eugenio Cerutti, Giovanni Dell'Ariccia and Maria Soledad Martínez Pería, 'How Banks Go Abroad: Branches or Subsidiaries?' (2007) 31 *Journal of Banking & Finance* 1669, at 1669–1692; Jonathan Fiechter et al, *Subsidiaries or Branches: Does One Size Fit All?* (IMF Staff Discussion Note SDN/11/04, 2011), at 11–12; Tobias H. Tröger, 'Organizational Choices of Banks and the Effective Supervision of Transnational Financial Institutions' (2013) 48 *Texas International Law Journal* 177, Sec. III.

[8] According to Article 4.1(55) of MiFID II, the home State Member of investment firms means: '(i) if the investment firm is a natural person, the Member State in which its head office is situated'; '(ii) if the investment firm is a legal person, the Member State in which its registered office is situated'; and '(iii) if the investment firm has, under its national law, no registered office, the Member State in which its head office is situated'.

[9] According to Article 4.1(56) of MiFID II, the host State Member of investment firms means: 'the Member State, other than the home Member State, in which an investment firm has a branch or provides investment services and/or activities'.

services might be offered cross-borderly by an investment firm located in one Member State to clients in other countries without establishing any office in the clients' countries.[10] Due to technological improvement, especially the Internet, these kinds of services have become more prevalent. Home Member States are getting more and more supervisory tasks in supervising this type of investment conduct.[11] Second, investment firms could set up an office in another Member State via a subsidiary for the physical promotion of their business. Subsidiaries are separately incorporated in other Member States, having their own capital similar to domestic investment firms.[12] They are independent legal entities requiring separate authorisation and under supervision of their own home Member States.[13] Therefore, the home country control and the Single Passport regime are not applicable directly when investment services are provided by subsidiaries. These subsidiaries need to apply their own licences, so that they could enjoy the benefits of the Single Passport. Third, the establishment of branches that are an integral part of an investment firm[14] is another choice of investment firms for physical promotion of their business in other Member States. Having said that, where investment services are provided by branches, the home country control might be 'imperfect'[15] and 'not entirely clear'.[16] Specifically, in the MiFID regime (whether

[10] S. J. Key and H. S. Scott, above note 6, at 16.
[11] Article 34 of MiFID II.
[12] Article 4.1(33) of MiFID II, and Seventh Council Directive 83/349/EEC on consolidated accounts, 1983 OJ L193.
[13] European Commission, Supervision of Branches under MiFID, MARKT/G/3/MV D(2007) 2386, June, 2007, para. 5, available at:
<http://ec.europa.eu/internal_market/securities/docs/isd/mifid-branches_en.pdf>
(accessed June, 2017).
[14] Article 4.1(30) of MiFID II.
[15] Gérard Hertig, 'Imperfect Mutual Recognition for EC Financial Services' (1994) 14 *International Review of Law and Economics* 177, at 180–185.
[16] Eva Lomnicka, 'The Home Country Control Principle in the Financial Services Directives and the Case Law' (2000) 11 *European Business Law Review* 324, at 330.

MiFID I[17] or MiFID II[18]), prudential supervision, as well as the using of the Single Passport, and the monitoring of compliance with the investor protection provisions, are granted to home Member States,[19] but host Member States retain their role in monitoring compliance with the investor protection provisions in the case of branches, provided that the services were offered by the branch within their territories.[20] Also, host Member States have powers to require branches of firms to provide necessary information.[21] This clearly rests upon closer co-operation between home and host Member States, with some confusion about the transaction reporting requirements in practice.[22] If a branch infringes the obligations within MiFID II, host Member States may further take relative precautionary measures.[23] By and large, the aforementioned 'host' powers prove that the nature of contractual obligations between investment firms and their clients will always provide a role for host Member States.[24] It is sometimes appropriate for NCAs of host Member States to 'assume responsibility for enforcing obligations' 'in relation to business conducted through a branch within the territory

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[17] Directive 2004/39/EC on markets in financial instruments, 2004 OJ L 145/1. ('MiFID I')

[18] Directive 2014/65/EU on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, 2014 OJ L173/349. ('MiFID II')

[19] Article 34 of MiFID II.

[20] Article 35.8 of MiFID II.

[21] Article 85.2 of MiFID II.

[22] For example, if a transaction conducted by a branch, should this branch either reports this transaction to the NCA of its home Member State directly or the NCA of the host Member State would convey such information that has been reported by the branch to the NCA of the branch's home Member State? Nathalie Aubry and Michael McKee, 'MiFID: Where Did It Come From, Where Is It Taking Us?' (2007) 22 *Journal of International Banking Law and Regulation* 177, at 184. In terms of this issue, it was highlighted in the discussion paper of MiFID II/MiFIR (see ESMA, Discussion Paper: MiFID II/MiFIR, ESMA/2014/548, May, 2014, para. 128), but it is now resolved by a regulatory technical standard of MiFIR. Investment firms only need to report the transaction once: see Commission Delegated Regulation (EU) …/… with regard to regulatory technical standards for the reporting of transactions to competent authorities, in particular Article 14, available at: <http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160728-rts-22_en.pdf> (accessed June, 2017).

[23] Article 86 of MiFID II.

[24] Emilios Avgouleas, 'The New EC Financial Markets Legislation and the Emerging Regime for Capital Markets' (2004) 23 *Yearbook of European Law* 321, at 353.

where the branch is located', since the NCAs are 'closest to the branch' and are 'better placed to detect and intervene in respect of infringements of rules governing the operations of the branch'.[25]

Furthermore, in practice, the home/host divide of investment conduct supervision in case of branches is not so clear-cut. The wording of Article 35.8 of MiFID II (the same as Article 32.7 of MiFID I), 'by the branch within its territory', reveals a 'grey area'[26] with various possible interpretations. Although some argue the most satisfactory and policy-matching interpretation is that all services provided from a branch are engaged in within the relevant Member State,[27] CESR[28] and the Commission settled a complicated way to give clarity of the wording of Article 35.8 of MiFID II/Article 32.7 of MiFID I:

(i) '[w]hen both the branch through which the service is provided and the client are in the host Member State, responsibility for supervising the obligations [...] should be allocated to the host competent authority';

(ii) '[w]hen the client is in the home Member State of the head office, (i.e. the home Member State), the competent authority responsible for supervising these same obligations should be that of the home Member State';

(iii) '[...] where the client is not either in the Member State of the branch or in the

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[25] Recital 90 of MiFID II.
[26] European Commission, Supervision of Branches under MiFID, above note 13, para. 8.
[27] Etay Katz, 'MiFID - Practical Issues for Implementation' (2007) 1 *Law and Financial Markets Review* 401, at 403; Bob Penn, 'Markets in Financial Instruments Directive ('MiFID'): Conduct of Business' (2007) 22 *Journal of International Banking and Financial Law* 20, at 21.
[28] CESR, The Passport under MiFID: Recommendations for the Implementation of the Directive 2004/39/EC, CESR/07-337b, May, 2007, at 7, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/07_337.pdf> (accessed June, 2017).

> Member State of the head office[,]' the allocation of supervisory responsibility has to be decided on a case by case basis.[29]

Thus, when in the case of situation (iii), where there is an area that results in 'dual supervision', there should be an effective shared and common supervision of the branches between the NCAs of home and host Member States;[30] and NCAs of home and host Member States have a legal obligation to co-operate, with a precautionary power of host Member States in limited circumstances;[31] NCAs should establish a Memoranda of Understanding ('MoU') to determine the practical arrangements for their co-operation in the supervision of branches.[32] Given this, a Protocol for building a multilateral MoU for supervision of branches was issued.[33]

In summary, the competence divide of home/host Member States is complex in the MiFID regime, depending upon different methods of providing transnational investment services as shown in Table III-1 below. The most unclear area is the middle column, where investment services are provided by branches in host Member States. As Professor Moloney describes:

> '[the current system of] branch control might be regarded as displaying the advantages of home-Member-State control with respect to market integration, in that it avoids the application of multiple regimes, and of host-Member-State

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29 European Commission, Supervision of Branches under MiFID, above note 13, para. 8.
30 European Commission, Supervision of Branches under MiFID, ibid, para. 9.
31 Recital 153 and Articles 79–87 of MiFID II.
32 European Commission, Supervision of Branches under MiFID, above note 13, para. 10.
33 CESR, Protocol on the Supervision of Branches under MiFID, CESR/07-672b, October, 2007, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/07_672b_update.pdf> (accessed June, 2017).

control, in that it reflects the proximity of the branch regime to the investor/branch relationship and the investor's familiarity with the regulatory regime.'[34]

Moreover, this issue may be even more troublesome, because whether the service is provided within the territory of the host Member States is indeterminable due to the development of e-commerce.[35] There is no uniform standard, like private international law, to resolve this issue between NCAs.[36] Therefore, this fragmentation of powers and responsibilities between home and host Member States severely constrains NCAs' abilities to supervise their markets and cross-border firms active in their jurisdictions.[37]

Table III-1: Home Country Control of Investment Conduct Supervision in MiFID II

Services are provided by / Services are received by	Head Office in Home State (A)	Branches in Host State (B)	Subsidiaries in Host State (B)
Clients in Home State (A)	Home-State Supervisor (A)	Home-State Supervisor (A)	Host-State Supervisor (B)
Clients in Host State (B)	Home-State Supervisor (A)	Host-State Supervisor (B)	Host-State Supervisor (B)
Clients in Other State (C)	Home-State Supervisor (A)	Home- & Host-State Co-Supervision (A+B)	Host-State Supervisor (B)

2.2. Overlaps of 'Two Peaks' within Home/Host Country Divide

Besides the foregoing complex allocation of competence between the home and

[34] Niamh Moloney, 'The Regulation of Investment Services in the Single Market: The Emergence of a New Regulatory Landscape' (2002) 3 *European Business Organization Law Review* 293, at 333–334.
[35] Simon Crown, 'Scope, Authorisation and Passporting' in Jonathan Herbst (ed), *A Practitioner's Guide to MiFID II* (2nd edn, Sweet & Maxwell, 2015), at 54.
[36] For more discussion about this in private international law: see Section 4.3 of CHAPTER V (pp. 240–250).
[37] Lucia Quaglia, 'Financial Regulation and Supervision in the European Union After the Crisis' (2013) 16 *Journal of Economic Policy Reform* 17, at 26. See further in Section 4.3 below (pp. 121–128).

host Member States, if investment services are offered by a branch within a host Member States' territories, another tension will emerge due to the overlap between prudential supervision and conduct supervision. This is because the borderline between these 'two peaks' is not always clear.[38] For example, according to Article 35.8 of MiFID II, only the obligations laid down in Articles 24, 25, 27 and 28[39] are supervised by NCAs of host Member States. However, the general conflict-of-interest requirement under Article 23 is not listed in Article 35.8 of MiFID II, and Article 16.3.1, regarding the organisational requirement to prevent conflicts of interest, is a home Member States' duty.[40] Given the fact that some of the supervision of the conflict-of-interest requirement are host Member States' duty but others are home Member States', both home and host Member States may sanction for infringements of the conflict-of-interest requirement.[41] Furthermore, in order 'to detect and investigate potential cases of market abuse, to monitor the fair and orderly functioning of markets, as well as the activities of investment firms',[42] host Member States are still empowered to enforce the record-keeping obligation[43] and to supervise transaction reporting of investment

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[38] Guido Ferrarini, 'Towards a European Law of Investment Services and Institutions' (1994) 31 *Common Market Law Review* 1283, at 1305; Eddy Wymeersch, *The European Banking Union, a First Analysis* (Financial Law Institute Working Paper Series WP 2012-07 2012), at 5; Eilís Ferran, 'European Banking Union: Imperfect, But It Can Work' in Danny Busch and Guido Ferrarini (eds), *European Banking Union* (Oxford University Press, 2015), para. 3.14; Niamh Moloney, 'Banking Union and the Implications for Financial Market Governance in the EU: Convergence or Divergence?' in Danny Busch and Guido Ferrarini (eds), *European Banking Union* (Oxford University Press, 2015), para. 16.71.
[39] These are the general requirement, the marketing requirement, the information requirement, part of the conflict-of-interest requirement, the quality-of-service requirement and part of the best execution requirement. See all of these in Sections 3.3.2 to 3.3.7 of CHAPTER II (pp. 37–56).
[40] Article 16.1 of MiFID II. See further in Section 3.3.5 of CHAPTER II (pp. 43–48).
[41] Article 70.3(a) of MiFID II.
[42] Recital 32 of Regulation (EU) No 600/2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, 2014 OJ L173/84. ('MiFIR')
[43] Article 16.11 of MiFID II.

firms.[44] This, inevitably, would cause an ambiguity of supervision between host and home Member States in the conflict-of-interest regime.[45] Host Member States may draw up rules of investment conduct to avoid conflicts of interest, or to ensure fair treatment in case that such conflicts cannot be avoided, but, at the same time, home Member States are vested with the power to require a certain structure and organisation of investment firms so that the risk of conflicts of interest is minimised. In a worst instance, home Member States' organisational rules for personal transactions by the firm's employees may conflict with host Member States' conduct rules on conflicts of interest. There is another similar example of the overlapping duty between the home and host Member States in relation to the product governance policy between Article 16.3 and Article 24.2 of MiFID II.[46] This might be the reason why Article 16.3.7 of MiFID II has to set out that the requirements of Article 16.3 'shall be without prejudice to all other requirements'. In addition, the new compliance requirement of Article 25.1, with regard to the assessment of knowledge and competence of investment firms' staff, may also overlap with the organisational requirement of Article 16.2 in MiFID II. The former is supervised by NCAs of host Member States, while the latter is by home Member States.[47] On the whole, tension between home and host Member States caused by the overlap of 'two peaks' in MiFID II can be summarised in Table III-2 below. The

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[44] Articles 24–26 of MiFIR, together with Article 35.8 of MiFID II.
[45] Yannis V. Avgerinos, 'Problems with Home Control and Investment Services' in Mads Andenas and Yannis Avgerinos (eds), *Financial Markets in Europe: Towards a Single Regulator?* (Kluwer Law International, 2003), at 100–101.
[46] For further discussion regarding the product governance, please see Section 3.3.3 and Section 3.3.8 of CHAPTER II (p. 39 and pp. 57–58).
[47] See Articles 35.8 and 16.1 of MiFID II.

predecessor of the MiFID I, ISD,[48] had tried to mitigate them by giving priority to conduct supervision.[49] In the absence of a similar provision within MiFID II, the only solution in the current system is the co-operation obligation between NCAs.[50] However, there is often no plain answer to the question that either the management model of Article 16,[51] or the supervision model of other rules is more effective or corrective. How to mediate this tension between home and host Member States is a difficult job for the EU.

Table III-2: Tension of Two Peaks in MiFID II

Obligation	Provision	Supervisor	Reconcilement
Conflict-of-Interest Policy	Article 23	Home State	Article 16.3.7? + Articles 79–87?
	Article 16.3.1		
	Articles 24.7–24.10	Host State	
Compliance Policy	Article 16.2	Home State	Articles 79–87?
	Article 25.1	Host State	
Product Governance Policy	Articles 16.3.2–16.3.6	Home State	Article 16.3.7?
	Article 24.2	Host State	

[48] Council Directive 93/22/EEC on investment services in the securities field, 1993 OJ L141/27. ('ISD')
[49] 5th indent of Article 10 of ISD.
[50] Articles 79–87 of MiFID II. See further in a regulatory technical standard: Commission Delegated Regulation (EU) .../... with regard to regulatory technical standards for the exchange of information between competent authorities when cooperating in supervisory activities, on-the-spot verifications and investigations, C(2016) 4415 final, June, 2016, available at:
<http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160714-rts-coop-btw-authorities_en.pdf> (accessed June, 2017)
See also a relevant guideline: ESMA, Guidelines on cooperation arrangements and information exchange: between competent authorities and between competent authorities and ESMA, ESMA/2014/298, March, 2014, available at:
<https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-298_guidelines_on_cooperation_arrangements_and_information_exchange_0.pdf> (accessed June, 2017).
[51] For a comprehensive analysis of the organisational requirement introduced by MiFID II: see Rik Mellenbergh, 'MiFID II: New Governance Rules in Relation to Investment Firms' (2014) 11 *European Company Law* 172, at 172–177.

In fact, due to the ambiguous ambits of the 'two peaks', the KID Regulation[52] and MiFIR[53] also create similar tension. For instance, the KID Regulation requires that NCAs of the Member State where the PRIIP is marketed should be responsible for the supervision of marketing of that PRIIP.[54] But home Member States are in charge of supervision of the KIDs, and host Member States may only require the *ex ante* notification for PRIIPs marketed within their territories.[55] Also, the product-oriented rules introduce another tension between the market monitoring and product intervention. According to Article 39.3 of MiFIR and Article 15.2 of the KID Regulation, where products 'are marketed, distributed or sold in or from their Member State', NCAs in where then shall have power to monitor, or to impose a sanction for infringements.[56] Same provisions also exist in the field of product intervention.[57] In this sense, a product may be monitored and supervised by more than one Member State, and this duplication will inevitably cause serious tension, particularly in case of cross-border services. Moreover, the viability of a distinction between the product and its marketing can be questioned in practice.[58] The place of the market might be unclear due to the technology.[59] For example, if a client visits the website of an investment firm

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[52] Regulation (EU) No 1286/2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), 2014 OJ L352/2. ('KID Regulation')
[53] Regulation (EU) No 600/2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, 2014 OJ L173/84. ('MiFIR')
[54] Recital 24 of Regulation (EU) No 1286/2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), 2014 OJ L352/2. ('KID Regulation')
[55] Article 5.2 of KID Regulation.
[56] Articles 70 and 72 of MiFID II and Article 22 of KID Regulation.
[57] Article 42.1 of MiFIR and Article 17.1 of KID Regulation.
[58] Jukha Snell and Mads Andenas, 'Exploring the Outer Limits - Restrictions on the Free Movement of Goods and Services' (1999) 10 *European Business Law Review* 252, at 265.
[59] William Blair and David Quest, 'Jurisdiction, Conflict of Law and the Internet' in Guido Ferrarini, Klaus J. Hopt and Eddy Wymeersch (eds), *Capital Markets in the Age of the Euro: Cross-Border Transactions, Listed Companies and Regulation* (Kluwer Law International, 2002), at 161–164.

and purchases financial products in such a way, where is the place of the market? One may argue that the client 'virtually' visited the home Member State of the investment firm; on the contrary, others may argue that the investment services are advertised and provided through a way of Internet into the host Member State's market, having no difference with other channels for distribution.[60] Therefore, without coherence and consistency of supervisory approaches in Member States, creating the EU-wide product governance and intervention regime may raise major difficulties.[61]

In brief, although the home/host divide of supervision has been described as the 'most significant building block' of the integrated financial market in the EU,[62] it is hard to clarify and optimise home-host responsibilities without a specific mechanism to resolve relevant issues.[63] As the Commission recognises, the fragmented supervision undermining the single market indeed 'imposes extra costs for financial institutions and increases the likelihood of failures of financial institutions with potentially additional costs' for European citizens.[64] This calls for an enhancement of supervisory powers of ESAs in some areas.

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[60] Philip Woolfson, 'Electronic Commerce and the Single Market in Financial Services in Europe: What Chances for Success?' (1997) 5 *Journal of Financial Regulation and Compliance* 306, at 312–313. For a same discussion regarding private international law in the EU law: see Section 4.3.1 of CHAPTER V (pp. 241–244).

[61] O. Cherednychenko Olha, 'Freedom of Contract in the Post-Crisis Era: Quo Vadis?' (2014) 10 *European Review of Contract Law* 390, at 419–421.

[62] The home/host model has been described as the 'most significant building block' of the integrated financial market. European Parliament, European Parliament resolution on financial services policy (2005-2010), P6-TA(2007)0338, para. 61.

[63] European Commission, White Paper on Financial Services Policy (2005-2010), May, 2005, part 3.2, available at:
<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52005DC0629&from=EN>
(accessed June, 2017).

[64] European Commission, Financial Supervision Package - Frequently Asked Questions, MEMO/10/434, September, 2010, Question 2, available at:
<http://europa.eu/rapid/press-release_MEMO-10-434_en.pdf> (accessed June, 2017).

3. Supranational System of Investment Conduct Supervision in the EU

3.1. Sector-Based Supervision of ESFS

Given the above incompleteness of the home country control, a supranational system to 'link' national supervision, more or less, is needed in the EU, but how to organise this is an open question. According to traditional patterns, the main business line of a financial institution determines its classification and authorisation, which results in a supervisory structure based on sectors: namely, banking, insurance and securities supervision.[65] In order to prevent intervention from other sectors, supervisors in each sector develop their own approaches, techniques and practices—the so-called 'sectoral'/'institutional', or 'three-pillar', approach of supervision.[66] However, attributed to market integration and financial innovation, 'many large financial institutions are involved in a cross-section of products and services', and 'they tend to operate along business lines without regard to the legal status of the entities in which the activity is technically situated, or recorded for supervisory purposes'.[67] This causes significant supervisory gaps of hybrid products, followed by competitive inequality caused by the fact that similar products and operations executed by institutions in different sectors may apply disparate provisions.[68] In order to tackle the competitive inequality problem,

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[65] Eddy Wymeersch, 'The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors' (2007) 8 *European Business Organization Law Review* 237, at 251–252.
[66] Ibid, at 252–253.
[67] G30, *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace* (Working Group on Financial Supervision, 2008), at 34.
[68] Tommaso Padoa-Schioppa, 'Financial Supervision - Inside or Outside Central banks?' in Dirk Shoenmaker, Jeroen J.M. Kremers and Peter J. Wierts (eds), *Financial Supervision in Europe* (Edward Elgar Publishing, 2003), at 162.

a 'functional' consideration is added into the supervisory structure. Under the 'functional approach', supervisory divide is 'determined by the business that is being transacted by the entity, without regard to its legal status',[69] but a similar challenge is that it could be extremely difficult to distinguish which activity comes within the jurisdiction of a particular supervisor, especially in the case of complex products and multi-sector activities.[70] The same problems and supervisory gaps, still exist. Therefore, if the institutional or functional approach is operable, an extensive consolidation and a clear allocation of responsibilities are needed.[71]

Due to the fact that no approach to supervision has been proven to be superior to others,[72] sector-based supervision plus a co-ordination platform—the so-called ESFS—is the structure chosen by the EU due to the historical roots.[73] ESAs were built to replace Level 3's Committees set in the Lamfalussy process,[74] and many Directives were then amended due to these institutional changes.[75] In addition, for tackling gaps between NCAs in supervising European financial conglomerates, the Joint Committee[76]

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[69] G30, above note 67, at 24. See also E. Wymeersch, 'The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors', above note 65, at 257–259.

[70] G30, ibid, at 35.

[71] T. Padoa-Schioppa, above note 68, at 164; Eric J. Pan, 'Four Challenges to Financial Regulatory Reform' (2010) 55 *Villanova Law Review* 743, at 758.

[72] Eilís Ferran, 'Institutional Design: The Choices for National Systems' in Niam Moloney, Eilís Ferran and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press, 2015), at 100–102.

[73] For a comprehensive history and critical evaluation of this sector-based model: see Veerle Colaert, 'European Banking, Securities, and Insurance Law: Cutting through Sectoral Lines?' (2015) 52 *Common Market Law Review* 1579, at 1579–1616.

[74] For more details of the Lamfalussy process: see Section 3.1 of CHAPTER II (pp. 23–27).

[75] Directive 2010/78/EU of the European Parliament and of the Council amending Directives 98/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC and 2009/65/EC in respect of the powers of the European Supervisory Authority (European Banking Authority), the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority), 2010 OJ L331/120. ('Omnibus Directive')

[76] CHARTER IV of EBA Regulation, ESMA Regulation and EIOPA Regulation.

plays an important role for providing a forum for co-operation between ESAs and NCAs.[77] For tackling another challenge, that no supervisor has sufficient information and authority to address systemic risk,[78] the ESRB was also established.[79] On the whole, the supervisory system of ESFS could be viewed as Table III-3 below,[80] but the grey area with respect to European capital markets supervision (in particular, investment conduct supervision) is the focus of this thesis.

Table III-3: Structure of ESFS[81]

Sector / Objective	Banking	Securities & Markets	Insurance & Pension
Macro-Prudential Supervision	ESRB		
Micro-Prudential Supervision	Joint Committee		
	EBA ⬍	ESMA ⬍	EIOPA ⬍
Conduct Supervision	NCAs	NCAs	NCAs

3.2. De Larosière Reforms Conferring ESMA More Supervisory Powers

As highlighted by the de Larosière report, CESR was considered as having a lack

[77] European Commission, Revision of the Financial Conglomerates Directive - Frequently Asked Questions, Memo/10/376, August, 2010, question 7, available at: <http://europa.eu/rapid/press-release_MEMO-10-376_en.pdf> (accessed June, 2017).

[78] G30, above note 67, at 35–36.

[79] Regulation (EU) No 1092/2010 of the European Parliament and of the Council on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, 2010 OJ L331/1. ('ESRB Regulation')

[80] After the SSM entered into operation in November 2014, the supervisory structure of banking sector in the EU was changed hugely. See further in Section 2.2 of CHAPTER VI (pp. 267–271).

[81] With regard to the difference between the macro-prudential, micro-prudential and conduct supervision, please see further in Section 4 and Footnote 38 of CHAPTER I (pp. 8–10).

of resources (or insufficient resources) and no means to deal with tension between NCAs.[82] Therefore, ESMA is established as an independent EU agency,[83] having legal personality,[84] with the aim 'to upgrade the quality and consistency of national supervision, strengthening oversight of cross-border groups'.[85] ESMA not only inherits similar powers from CESR, but also gets more 'hard' supervisory powers that CESR did not have.[86] However, it is important to note that ESMA still operates as a 'European Network Plus',[87] so, as some commentators have said, the de Larosière reforms 'did not substantially change the allocation of powers and responsibilities amongst authorities, but enhanced coordination mechanisms' in the EU.[88]

3.2.1. Enhanced Soft Powers

First of all, ESMA continues to play a general co-ordination role, as CESR did.[89] It shall 'facilitate the exchange of information',[90] and function as a centralised information point.[91] In addition, ESMA has a new power to request information from NCAs in order to carry out its duties assigned.[92] If the information is not available (or not made available in a timely fashion) from the NCAs, ESMA can request it from the relevant

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[82] The de Larosière report, above note 4, paras. 161–166.
[83] Article 1.5.4 of ESMA Regulation.
[84] Article 5.1 of ESMA Regulation.
[85] Recital 5 of ESMA Regulation.
[86] Articles 8.2(d)–(f) and (h)–(j) of ESMA Regulation. See details in Sections 3.2.1, 3.2.2 and 3.3 below (pp. 89–105).
[87] Saskia Lavrijssen-Heijmans and Leigh Hancher, 'European Regulators in the Network Sectors: Revolution or Evolution?' in G. Arts, W. Dicke and L. Hancher (eds), *New Perspectives on Investment in Infrastructures* (Amsterdam University Press, 2008), at 138–141.
[88] Guido Ferrarini and Luigi Chiarella, *Common Banking Supervision in the Eurozone: Strengths and Weaknesses* (ECGI Law Working Paper No 223/2013, 2013), at 38.
[89] Article 31 of ESMA Regulation.
[90] Articles 31(a) of ESMA Regulation.
[91] Articles 31(b) and (f) of ESMA Regulation.
[92] Article 35.1 of ESMA Regulation.

financial market participants directly.[93] On the counterbalance, ESMA shall also provide 'a centrally accessible database of registered financial market participants'.[94]

Second, given that ESFS is still based on a decentralised network, and NCAs would continue to carry out day-to-day supervision,[95] building a common supervisory culture is still needed for a consistent network in the EU. To this end, ESMA inherits peer review powers that CESR had for strengthening consistency in supervisory outcomes.[96] Although the effect of 'soft' peer reviews remains unclear, it seems to be effective in the promotion of communication and information flows at least.[97] From the viewpoint of this, the outcomes of peer reviews are multiple: first, peer reviews may contribute to 'a better understanding of the differences' between supervisory systems in Member States; second, peer reviews may 'give rise to initiatives in terms of regulation or recommendations'; and third, peer reviews may 'constitute a monitoring device' of Member States.[98] Furthermore, best practices may be identified and made public by peer reviews, as the fourth function.[99] This re-engineered and strengthened function of

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93 Article 35.6 of ESMA Regulation.

94 Article 8.2(j) of ESMA Regulation.

95 The de Larosière report, above note 4, rec. 18; Recital 9 of ESMA Regulation.

96 Article 30 of ESMA Regulation. Relative legislation also grants ESMA a peer review function in practice: see, e.g., Article 38 of Directive 2011/61/EU on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 2011 OJ L174/1 ('AIFMD'); Article 21 of Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories, 2012 OJ L201/1 ('EMIR'); Article 24 of Regulation (EU) No 909/2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012, 2014 OJ L257/1. ('CSDR')

97 Martino Maggetti and Fabrizio Gilardi, 'The Policy-Making Structure of European Regulatory Networks and the Domestic Adoption of Standards' (2011) 18 *Journal of European Public Policy* 830, at 836–844.

98 Eddy Wymeersch, 'The European Financial Supervisory Authorities or ESAs' in Eddy Wymeersch, Klaus J. Hopt and Guido Ferrarini (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (Oxford University Press, 2012), para. 9.179.

99 Recital 41 and Article 30.4 of ESMA Regulation.

peer reviews is considered as a future way to achieving supervisory convergence.[100] In addition, compared to CESR, ESMA Regulation opens a wider window on various forms of building a common supervisory culture between NCAs: ESMA may provide opinions to NCAs; promote an effective bilateral and multilateral exchange of information between NCAs; develop supervisory standards, especially on reporting; review the application of technical standards, guidelines and recommendations; establish training programmes; or even develop new practical instruments and convergence tools.[101] This leaves plenty of room for ESMA regarding further innovation on supervisory tools. For example, in accordance with ESMA's Supervisory Convergence Work Programme for 2017, besides guidelines, Q&A and peer reviews, 'application workshops' and 'training workshops' are also applicable tools for the sound, efficient and consistent implementation and supervision of MiFID II package.[102]

3.2.2. New Hard Powers

In addition to the enhanced soft powers indicated above, ESMA, compared to CESR, has been granted four new 'hard powers'. First, ESMA now plays an important role in monitoring how EU law (including technical standards) is enforced by NCAs, and ensures the consistent application of EU law.[103] Subject to a prior investigation into the alleged breach or non-application of EU law, ESMA may address recommendations

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[100] International Monetary Fund ('IMF, *European Union: Publication of Financial Sector Assessment Program Documentation—Technical Note on European Securities and Markets Authority* (IMF Country Report No 13/69, 2013), para. 84, available at: <http://www.imf.org/external/pubs/ft/scr/2013/cr1369.pdf> (accessed June, 2017).

[101] Article 29 of ESMA Regulation.

[102] ESMA, Supervisory Convergence Work Programme 2017, ESMA42-397158525-448 , February, 2017, paras. 86–87 and Annexes I & II, available at: <https://www.esma.europa.eu/sites/default/files/library/esma42-397158525-448_supervisory_convergence_work_programme_2017_0.pdf> (accessed June, 2017).

[103] Article 17 of ESMA Regulation.

to the NCAs for setting out the action that they should take.[104] If the NCAs do not correct their action after receiving the recommendations, the European Commission ('Commission') shall take into account these recommendations to issue a formal opinion to the NCAs for further procedures.[105] In this sense, the recommendations within this article (namely, Article 17 of ESMA Regulation) have *de facto* binding powers to NCAs. Moreover, if the NCAs do not comply the opinion issued by the Commission, ESMA may take a direct decision against to financial market participants in order to 'maintain or restore neutral conditions of competition in the market or ensure the orderly functioning and integrity of the financial system'.[106] Unanswered questions then remain about what steps ESMA could take if a financial institution was failed to comply with the direct decision made by ESMA, although this may not happen in reality since that NCAs would seldom persist in holding out against the combined views of the Commission and ESMA.[107]

Second, in an emergency case of 'adverse market developments that may seriously jeopardise the orderly functioning and integrity of financial market or the stability of the whole or part of the financial system',[108] ESMA shall either issue a confidential recommendation to the Council of the European Union ('Council') for requiring a meeting,[109] or even take individual decisions to instruct NCAs.[110] If the NCAs do not

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104 Article 17.3 of ESMA Regulation.
105 Article 17.4 of ESMA Regulation.
106 Article 17.6 of ESMA Regulation.
107 Eilís Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision' in Eddy Wymeersch, Klaus J. Hopt and Guido Ferrarini (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (Oxford University Press, 2012), para. 5.68.
108 Article 18.1 of ESMA Regulation.
109 Article 18.2(2) of ESMA Regulation.
110 Article 18.3 of ESMA Regulation.

comply with the decision issued by ESMA, ESMA may further take an individual decision to financial market participants directly.[111] However, ESMA's action taking in emergency cases are too onerous, especially this article (namely, Article 18 of ESMA Regulation) is subject to a fiscal safeguard set out in Article 38 of ESMA Regulation in order to ensure that no decision 'impinges in any way on the fiscal responsibilities of Member States'.[112] The decision of ESMA may be suspended by the notification from a Member State up to ten working days, plus eight weeks re-examination from the Council.[113] This is an incredibly long period in emergency cases.[114] In addition, given that ESMA has a task to monitor and assess market developments,[115] ESMA shall also develop common methodologies for assessment and common approaches to communication, all of which will be applied by NCAs.[116]

Third, although ESMA still could carry out non-binding mediation as CESR did,[117] it now has the possibility of settling binding disagreements between NCAs, in particular, in areas that require co-operation, co-ordination or joint decision-making by NCAs from more than one Member State.[118] After assisting NCAs in resolving their disputes,[119] ESMA could resolve the dispute unilaterally by 'binding' decisions to instruct the NCAs to take (or refrain from) an action if the NCAs fail to reach an

111 Article 18.4 of ESMA Regulation.
112 Article 38.1 of ESMA Regulation.
113 Articles 38.3 and 38.4 of ESMA Regulation.
114 E. Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision', above note 107, at 147; Nicolette Kost de Sevres and Lorenzo Sasso, 'The New European Financial Markets Legal Framework: A Real Improvement? An Analysis of Financial Law and Governance in European Capital Markets from A Micro- and Macro-Economic Perspective' (2012) 7 *Capital Markets Law Journal* 30, at 49–50.
115 Article 8.1(f) of ESMA Regulation.
116 Article 32 of ESMA Regulation.
117 Article 31(c) of ESMA Regulation.
118 Article 19 of ESMA Regulation.
119 Articles 19.1 and 19.2 of ESMA Regulation.

agreement.[120] However, the fiscal safeguard of Article 38 of ESMA Regulation is applied to ESMA's power of settling disagreements in cross-border situations.[121] ESMA's decision may be suspended by the notification from a Member State up to three months.[122] Some argue this long period might hinder efficient cross-border supervision.[123] Thus, in order to find a fine balance of this fiscal safeguard, Recital 50 of ESMA Regulation clarifies that 'this safeguard mechanism should not be abused', in particular in relation to a decision taken by ESMA which 'does not have a significant or material fiscal impact'.[124] In this case, the fiscal safeguard set in Article 38 provides a well-balanced function reconciling the responsibilities between ESMA and NCAs.[125]

Finally, ESMA has a new task to monitor new and existing financial activities.[126] ESMA could issue warnings on risky financial activities.[127] In case that these activities 'threaten the orderly functioning and integrity of financial market or the stability of the whole or part of the financial system', ESMA could even temporarily prohibit or restrict certain activities.[128] It should be further noted that this banning power is subject to either the condition laid down in Article 18 in case of an emergency situation or the conditions laid down in other specific legislation.[129] On the whole, the new legally

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120 Article 19.3 of ESMA Regulation.
121 Article 38.2 of ESMA Regulation.
122 Ibid.
123 Wim Fonteyne et al, *Crisis Management and Resolution for a European Banking System* (IMF Working Paper WP/10/70, 2010), at 7–8.
124 See also Article 38.5 of ESMA Regulation.
125 Pierre Schammo, 'EU Day-to-Day Supervision or Intervention-Based Supervision: Which Way Forward for the European System of Financial Supervision?' (2012) 32 *Oxford Journal of Legal Studies* 771, at 793–794.
126 Article 9.2 of ESMA Regulation.
127 Article 9.3 of ESMA Regulation.
128 Article 9.5 of ESMA Regulation. See further in Section 3.3.2 below (pp. 100–105).
129 Ibid. For further details of the conditions laid down in other specific legislation: see Section 3.3.1 below (pp. 96–99).

binding powers of ESMA are the most important features of the de Larosière reforms.[130] In contrast to CESR, ESMA is meant to have 'real teeth'.[131] ESMA now works as a 'supervisor of supervisors' and a 'system supervisor', hovering 'above' and 'beside' NCAs.[132]

3.3. Increasing Direct Supervisory Powers of ESMA

Since the task of ESMA is to ensure 'the integrity, transparency, efficiency and orderly functioning' of the highly integrated securities markets in the EU,[133] the current level granted to ESMA might be insufficient[134]— truly pan-European supervisory powers are needed.[135] As anticipated by CESR's 'Himalaya Report', a certain number of fields might be suitable for centralised supervision at the EU level in the near future: (i) EU-wide public offerings of highly standardised products; (ii) public offering of standardised UCITS; (iii) application of accounting standards for listed companies; and (iv) certain trans-European market infrastructures.[136] Therefore, ESMA is getting more and more direct supervisory powers, and its role is changing from 'a supervisor of

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130 E. Wymeersch, 'The European Financial Supervisory Authorities or ESAs', above note 98, at 249–276.
131 Pierre Schammo, 'The European Securities and Markets Authority: Lifting the Veil on the Allocation of Powers' (2011) 48 *Common Market Law Review* 1879, at 1880.
132 Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press, 2014), at 973.
133 Article 1.5(b) of ESMA Regulation.
134 Sony Kapoor, *Emergent Global Challenges: What Europe Needs to Do to Tackle the Triple Crises of Tax, Finance and Climate* (European Parliament's Special Committee on the Financial, Economic and Social Crisis (CRIS) Research Paper, 2010), at 16, available at: <http://www.europarl.europa.eu/RegData/etudes/note/join/2010/433452/IPOL-JOIN_NT(2010)433452_EN.pdf> (accessed June, 2017).
135 Deutsche Bank Research, Financial Supervision in the EU, August, 2011, at 15, available at: <https://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000276501/Financial+supervision+in+the+EU%3A+Incremental+progr.PDF> (accessed June, 2017).
136 CESR, Preliminary Progress Report: Which Supervisory Tools for the EU Securities Markets? An Analytical Paper By CESR, CESR Ref:04~333f, October, 2004, at 17, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/04_333f.pdf> (accessed June, 2017).

supervisors' to a direct supervisor step by step. This represents a radical shift from the model 'which hitherto has been based on the allocation of supervisory jurisdiction between home and host supervisors', towards centralised supervision at the EU level.[137]

3.3.1. Direct Powers conferred by Sectoral Legislation

There are three cases that new direct supervisory powers are conferred to ESMA by independent and sectoral legislation. Credit rating agencies ('CRAs') are the first case to be placed under the direct supervision of ESMA.[138] ESMA now has an exclusive power on the registration of CRAs in the EU.[139] The Commission only has limited powers on registration and supervisory fees.[140] In order to fulfil its supervisory role on CRAs,[141] ESMA is empowered to request for information[142] and to conduct general investigations[143] and on-site inspections.[144] In case the CRAs infringe the conflict-of-interest, organisational or operational requirements[145] and disclosure requirements[146] mentioned in Annex III of CRA Regulation, ESMA may, by 'taking into account the nature and seriousness of the infringement',[147] either withdraw the CRAs' registration, temporarily ban the CRAs from issuing credit ratings, suspend the use of credit ratings issued by the CRAs, require the CRAs to end their infringements,

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137 Niamh Moloney, 'Reform or Revolution? The Financial Crisis, EU Financial Markets Law and the European Securities and Markets Authority' (2011) 60 *International and Comparative Law Quarterly* 521, at 528.
138 Regulation (EC) No 1060/2009 on credit rating agencies amended by Regulation (EU) No 513/2011, 2011 OJ L145/30. ('CRA Regulation')
139 Articles 14–19 of CRA Regulation.
140 Article 19.2 of CRA Regulation; see also Commission Delegated Regulation (EU) No 272/2012 supplementing Regulation (EC) No 1060/2009 with regard to fees charged by the European Securities and Markets Authority to credit rating agencies, 2012 OJ L90/6.
141 Article 21 of CRA Regulation.
142 Article 23b of CRA Regulation.
143 Article 23c of CRA Regulation.
144 Article 23d of CRA Regulation.
145 Part I of Annex III of CRA Regulation.
146 Part II of Annex III of CRA Regulation.
147 Article 24.2 of CRA Regulation.

or issue public notices.[148] If the CRAs, intentionally or negligently, commit these infringements, ESMA shall also impose fines on them.[149] ESMA could even impose periodic penalty payments to compel the CRAs put an end to their infringements.[150] Although the Commission is empowered to adopt rules of procedure for the exercise of the power to impose fines,[151] the files submitted by independent investigating officers who are within ESMA are the basis of ESMA's decision in taking any supervisory measure.[152] In addition, credit ratings that are related to entities established, or financial instruments issued in third countries, and that are issued by a CRA established in a third country, might apply for certification from ESMA, in order to be used in the EU without an endorsement of EU-based CRAs.[153] This procedure requires (i) a previous equivalence decision made by the Commission regarding the third-country regulatory and supervisory regime on CRAs[154], and (ii) the establishment of a co-operation arrangement between ESMA and the relevant third-country authorities.[155]

The second case relates to trade repositories ('TRs'),[156] which is similar to the supervisory regime of CRAs. Under EMIR, ESMA now has direct responsibilities regarding the registration, supervision and recognition of TRs.[157] EU-based TRs need

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148 Article 24.1 of CRA Regulation.
149 Article 36a of CRA Regulation.
150 Article 36b.1(a) of CRA Regulation.
151 Article 23e.7 of CRA Regulation; see also Commission Delegated Regulation (EU) No 946/2012 supplementing Regulation (EC) No 1060/2009 with regard to rules of procedure on fines imposed to credit rating agencies by the European Securities and Markets Authority, including rules on the right of defence and temporal provisions, 2012 OJ L282/33.
152 Article 23e of CRA Regulation.
153 Article 5 of CRA Regulation.
154 Article 5.1(b) of CRA Regulation.
155 Article 5.1(c) of CRA Regulation.
156 'Trade repository' means 'a legal person that centrally collects and maintains the records of derivatives': see Article 2(2) of Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories, 2012 OJ L201/1. ('EMIR')
157 TITLE VI of EMIR.

to be authorised by ESMA.[158] ESMA could adopt a registration decision, or a decision refusing or withdrawing registration with its discretion, and the only need is to communicate the decisions made to the Commission.[159] The same as the supervisory powers on CRAs, ESMA could make a request for information[160] and conduct general investigations[161] and on-site inspections.[162] The Commission only has limited powers on supervisory fees.[163] Also, if TRs committed infringements relating to organisational (conflicts of interest) requirements, operational requirements, transparency and the availability of information, or obstacles to the supervisory activities listed in Annex I of EMIR, ESMA, by taking into account the nature and seriousness of the infringement, could require the TRs end their infringements, impose fines, issue public notices or even withdraw their registration.[164] ESMA could further compel the TRs put an end to their infringements by imposing periodic penalty payments.[165] Before ESMA takes the decision, it needs to appoint independent investigating officers conducting investigation and follow the detailed rules of procedure published by the Commission.[166] Furthermore, third-country (non-EU) based TRs that are doing business in the EU need to be recognised by ESMA.[167] A precondition of this recognition is the Commission

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158 Articles 55–59 of EMIR.
159 Article 59.2 of EMIR.
160 Article 61 of EMIR.
161 Article 62 of EMIR.
162 Article 63 of EMIR.
163 Article 72.3 of EMIR; see also Commission Delegated Regulation (EU) No 1003/2013 supplementing Regulation (EU) No 648/2012 with regard to fees charged by the European Securities and Markets Authority to trade repositories, 2013 OJ L279/4.
164 Article 73 of EMIR.
165 Article 66.1(a) of EMIR.
166 Article 64 of EMIR; see also Commission Delegated Regulation (EU) No 667/2014 supplementing Regulation (EU) No 648/2012 with regard to rules of procedure for penalties imposed on trade repositories by the European Securities and Markets Authority including rules on the right of defence and temporal provisions, 2014 OJ L179/31.
167 Article 77.1 of EMIR.

has assessed third countries having equivalent and enforceable regulatory and supervisory frameworks by adopting implementing acts.[168] Furthermore, in Article 25 of EMIR Regulation, ESMA is empowered with a power of recognising third-country central counterparties ('CCPs')[169] based on the Commission's Level 2 rules.

The third case relates to the registration of third-country investment firms within MiFIR: a third-country firm may provide investment services to eligible counterparties and per se professional clients[170] on a cross-border basis without the establishment of a branch, where such firm is registered with ESMA.[171] Although the major task of monitoring this firm is left to the third country, ESMA has a power to withdrawal the registration of the firm.[172] The Commission's equivalence decision, with regard to whether 'the prudential and business conduct framework of a third country can be considered to have equivalent effect',[173] is a prior requirement of ESMA's decision taking, so the decisions of registration of third-country firms made by ESMA are still subject to the Commission.[174] In case that ESMA would like to withdraw this registration, ESMA shall also inform the Commission to assess whether the conditions (namely, the prudential and business conduct framework of a third country can be considered to have equivalent effect) under the equivalence decision still persist.[175]

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168 Article 77.2(a) conferring Article 75.1 of EMIR.

169 'Central counterparties' means 'a legal person that interposes itself between the counterparties to the contracts traded on one or more financial markets, becoming the buyer to every seller and the seller to every buyer': see Article 2(1) of EMIR.

170 For further discussion about the client classification of the MiFID regime: see Section 3.3.1 of CHAPTER II (pp. 34–37).

171 Article 46.1 of MiFIR. If a third country firm would like to provide investment services to retail clients and opted-up professional clients, it need to establish a branch with a prior authorisation by Member States in accordance with Article 39 of MiFID II.

172 Article 49 of MiFIR.

173 Article 47.1 of MiFIR.

174 Article 46.2 (a) conferring Article 47.1 of MiFIR.

175 Article 49.3 of MiFIR.

3.3.2. Direct Powers based on Article 9.5 of ESMA Regulation

Besides above three cases, Article 9.5 of ESMA Regulation provides another legal basis for conferring direct supervisory powers to ESMA. This article opens up the possibility of a much more centralised form of control over financial innovation and provides a reserve power to set the relationship between ESMA and the European capital markets.[176] Even if in the absence of emergency cases, the power of Article 9.5 of ESMA Regulation could still be conferred by sectoral legislation. Three examples can be found in the EU law.

First, Article 47 of AIFMD[177] confers on ESMA a 'look-like' direct supervisory power. Although this article is also based on Article 9 of ESMA Regulation, it confers on ESMA a power to request NCAs to prohibit or restrict certain non-EU alternative investment fund managers ('AIFMs'),[178] if (i) a 'substantial threat exists' to 'the orderly functioning and integrity of the financial market or to the stability of the whole or a part of the financial system' in the EU, and 'there are cross border implications'; and (ii) no NCA 'has taken measures to address the threat', or 'one or more' of the NCAs 'have taken measures that do not adequately address the threat'.[179] The measures requested by ESMA shall: (i) 'effectively address the threat', (ii) 'not create a risk of regulatory arbitrage', and (iii) 'not have a detrimental effect on the efficiency of the financial markets'.[180] The power of this Article, strictly speaking, is not a direct supervisory

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[176] Iain G. MacNeil, *An Introduction to the Law on Financial Investment* (2nd edn, Hart Publishing, 2012), at 65. See further in pages 94–95 above.
[177] Directive 2011/61/EU on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 2011 OJ L174/1. ('AIFMD')
[178] Article 47.4 of AIFMD.
[179] Article 47.5 of AIFMD.
[180] Article 47.6 of AIFMD.

power on market participants, but an 'indirect' supervisory power on NCAs. However, four years after the deadline for transposition of AIFMD, around July, 2017,[181] the Commission should commence a review of the application and the scope of this Directive, and it may entrust ESMA with further supervisory responsibilities in the field of authorisation and supervision of non-EU AIFMs.[182] Given the other two examples below, it is highly likely that ESMA will be granted a direct supervisory power of non-EU AIFMs then.

Second, according to Article 28 of Short Selling Regulation,[183] ESMA has direct intervention powers in exceptional circumstances to restrict short selling, credit default swaps and other transactions with a temporary nature. However, ESMA could take this decision only if: (i) there is 'a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system' in the EU and 'there are cross-border implications'; and (ii) no NCA 'has taken measures to address the threat' or 'one or more' of NCAs 'have taken measures that do not adequately address the threat'.[184] The Commission is empowered to adopt Level 2 rules in determining what is a threat.[185] ESMA shall also consider whether the measures taken: (i) could 'significantly address the threat'; (ii) 'do not create a risk of regulatory arbitrage'; and (iii) 'do not have a detrimental effect on the efficiency of financial markets'.[186] Furthermore, this power should be exercised 'only for such period and to the extent

181 Article 66 of AIFMD.
182 Recital 91 of AIFMD.
183 Regulation (EU) No 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps, 2012 OJ L86/1. ('Short Selling Regulation')
184 Article 28.2 of Short Selling Regulation.
185 Article 30 of Short Selling Regulation.
186 Article 28.3 of Short Selling Regulation.

necessary to deal with the specific threat'.[187]

Third, MiFIR introduces two articles conferring direct supervisory powers to ESMA.[188] According to Article 40 of MiFIR, ESMA will have temporary product intervention powers on the marketing, distribution or sale of certain financial instruments, or on a type of financial activity or practice, if: (i) 'the proposed action addresses a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the whole or part of the financial system' in the EU; (ii) 'regulatory requirements under EU law do not address the threat'; and (iii) NCAs 'have not taken action to address the threat or the actions that have been taken do not adequately address the threat'.[189] The Commission shall adopt Level 2 rules in determining the first of foregoing conditions concerning investor protection, market integrity or financial stability.[190] ESMA shall ensure the supervisory actions takes: (i) 'do not have a detrimental effect on the efficiency of financial markets or on investors'; (ii) 'do not create a risk of regulatory arbitrage'; and (iii) have 'been taken after consulting with relevant authorities, where the measures relates to agricultural commodities derivatives'.[191] This new power mainly deals with overall financial stability and orderly functioning of markets, and does 'not imply any requirement to introduce or apply a product approval or licensing'.[192] Furthermore, in order to address 'excessive commodity price volatility',[193] Article 45 of

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[187] Recital 36 of Short Selling Regulation.
[188] For similar powers of EBA, EIOPA and NCAs: see Section 3.3.8 of CHAPTER II (pp. 58–60).
[189] Article 40.2 of MiFIR.
[190] Article 40.8 of MiFIR.
[191] Article 40.3 of MiFIR.
[192] Recital 29 of MiFIR.
[193] Recital 125 of MiFID II.

MiFIR also provides ESMA with position management powers, allowing it to: (i) 'request all relevant information from any person regarding the size and purpose of a position or exposure entered into via a derivative';[194] (ii) 'require such people to reduce the size of or to eliminate their position or exposure, having analysed this information';[195] or (iii) 'as a last resort, limit the ability of a person from entering into a commodity derivative'.[196] The above measures could only be taken if: (i) they could 'address a threat to the orderly functioning and integrity of financial markets'; and (ii) NCAs 'have not taken measures to address the threat or the measures taken do not sufficiently address the threat'.[197] ESMA shall ensure the measures it takes: (i) 'significantly addresses the threat'; (ii) 'does not create a risk of regulatory arbitrage'; and (iii) 'does not have any of the following detrimental effects on the efficiency of financial markets'.[198] The Commission shall further adopt Level 2 rules to specify: (i) 'the existence of a threat'; (ii) 'the appropriate reduction of a position or exposure entered into via a derivative'; and (iii) 'the situations where a risk of regulatory arbitrage could arise'.[199]

Overall, all of the current direct supervisory powers of ESMA could be summarised as following Table III-4 shows. On the one hand, ESMA's direct powers are subject to many constraints. They normally require detailed pre-requests, conditions and limited choices of actions that ESMA may take, so that ESMA will not abuse these

194 Article 45.1(a) of MiFIR.
195 Article 45.1(b) of MiFIR.
196 Article 45.1(c) of MiFIR.
197 Article 45.2 of MiFIR.
198 Article 45.3 of MiFIR.
199 Article 45.10 of MiFIR.

powers. On the other hand, it appears that ESMA are not merely an agency now, as it has some 'independent' supervisory powers.[200] ESMA is now operating as a unique 'quasi-regulator' within a complex, formal, institutional structure created by the EU Treaties.[201] In the light of these examples, it could be reasonably anticipated that direct supervisory powers might extend to the cases of market abuse and money laundering, since these direct powers of ESMA can further harmonise supervisory powers across the EU.[202] The recent review of ESAs also provides similar recommendations towards a stronger role for ESMA on market function supervision.[203] It is suggested that the coverage of ESMA's supervision should be enlarged to include the Shareholders Rights Directive,[204] Takeover Directive,[205] shadow banking,[206] the enforcement of International Financial Reporting Standards ('IFRS')),[207] and to confer on ESMA more direct powers in relation to the highly integrated market infrastructure.[208]

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[200] Eddy Wymeersch, 'The Reforms of the European Financial Supervisory System – An Overview' (2010) 7 *European Company and Financial Law Review* 240, at 253.

[201] Cally Jordan, *International Capital Markets: Law and Institutions* (Oxord University Press, 2014), para. 12.12.

[202] Steven Maijoor, Investor Protection and an integrated EU-Capital Market, Better Finance for All – International Investor's Conference 2014, ESMA/2014/1747, December, 2014, at 9–10, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1474_steven_maijoor_-_investor_protection_and_an_integrated_eu-capital_market_-_dsw-better_finance_conference_wiesbaden_9_december_2014_0.pdf> (accessed June, 2017).

[203] European Commission, Report from the Commission to the European Parliament and the Council on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS), COM(2014) 509 final, August, 2014, available at: <http://ec.europa.eu/finance/general-policy/docs/committees/140808-esfs-review_en.pdf> (accessed June, 2017).

[204] Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies, 2007 OJ L184/17.

[205] Directive 2004/25/EC on takeover bids, 2004 OJ L142/12.

[206] See European Commission, Proposal for a Regulation of the European Parliament and of the Council on reporting and transparency of securities financing transactions, COM(2014) 40 final, January, 2014, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014PC0040> (accessed June, 2017).

[207] European Commission, Report from the Commission to the European Parliament and the Council on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS), above note 203, at 4.

[208] Ibid, at 13. The highly integrated market infrastructure may include the supervision of data providers, pan-EU funds and CCPs. See European Commission, Public Consultation on the Operations of the

Table III-4: Increasing Direct Supervisory Powers of ESMA

Types	Legislation & Time	Initiatives
Supervision of EU-based CRAs and Non-EU CRAs	CRA Regulation, 2009 & 2011	Based on Individual Legislation
Supervision of EU-based TRs and Non-EU TRs, Non-EU CCPs	EMIR, 2012	
Supervision of Non-EU Investment Firms	MiFIR, 2014	
Supervision of Short Selling	Short Selling Regulation, 2012	Based on Article 9.5 of ESMA Regulation
Product Intervention & Position Management Powers	MiFIR, 2014	
Supervision of Non-EU AIFMs	AIFMD, 2017 (expected)	

4. Challenges of Current System

4.1. Constitutionality of ESMA

Increasing the direct powers of ESMA shows that a trend of centralising supervision to the EU level is underway. However, whether this transfer is desirable or not, it always needs to be done with sensitivity in order to 'avoid upsetting the present constitutional balance'.[209] As admitted by ESMA, any further grant of direct supervisory powers to ESMA shall occur 'in very limited circumstances where the entity is pan-European and where there is a clear added value to the EU-level supervision'.[210]

European Supervisory Authorities, March, 2017, at 17–18, available at: <https://ec.europa.eu/info/sites/info/files/2017-esas-operations-consultation-document_en.pdf> (accessed June, 2017). ('ESA Consultation Paper')

[209] Alan Dashwood, 'States in the European Union' (1998) 23 *European Law Review* 201, at 213.

[210] ESMA, Frequently Asked Questions: A Guide to Understanding ESMA, ESMA/2011/009, January, 2011, at 9, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2011_009.pdf> (accessed June, 2017).

Therefore, a debate about the constitutionality of ESMA emerges.

In fact, although many agencies have worked for a long time in the EU, primary legislation was completely silent on the existence of agencies until the Treaty of Lisbon.[211] In the Treaty of Lisbon, many provisions mention these kinds of entities. First, Article 263 of the TFEU provides a legal basis for the CJEU to review the legality of 'acts of bodies, offices or agencies of the Union'. Second, Article 265 of the TFEU also clarifies that the rules governing actions for failure to act are applicable to 'bodies, offices and agencies of the Union which fail to act'. Third, Article 267(b) of the TFEU further confirms that courts and tribunals of Member States may refer questions concerning the validity and interpretation of 'acts of the institutions, bodies, offices or agencies of the Union' to the CJEU. Fourth, such acts may also be the subject of a plea of illegality, pursuant to Article 277 of the TFEU, so 'any party may, in proceedings in which an act of general application adopted by an institution, body, office or agency of the Union is at issue'. Although these provisions might be seen as the Treaty bases of EU agencies, these Treaty fixes do not bring about a constitutional revolution in the sense that judicial review of acts of agencies had already been confirmed in the practice of the General Court (the Court of First Instance prior to 2009) within the CJEU.[212] In this sense, the Treaty of Lisbon, as it stands, does not foresee the possibility of establishing an agency or conferring powers on it, but does foresee legal redress against

[211] Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, 2007 OJ C 306/1.

[212] See, e.g., CJEU, Case T-411/06, *Sogelma v EAR*, [2008] ECR II-2771, para. 37: '[...] any act of a Community body intended to produce legal effects vis-à-vis third parties must be open to judicial review'; CJEU, Case T-187/06, *Schräder v CPVO*, [2008] ECR II-3151, para. 59: 'where a Community authority is called upon, in the performance of its duties, to make complex assessments, it enjoys a wide measure of discretion, the exercise of which is subject to limited judicial review'.

the acts of such agencies.[213] There is still a need for clarifying the constitutionality in relation to the establishment of EU agencies.

4.1.1. *Meroni* and *Romano* Cases

Meroni v High Authority (the '*Meroni* case')[214] is a long-standing CJEU case law that raises a heated debate regarding ESMA's constitutionality.[215] The *Meroni* case ruled that an EU agency cannot be given a discretionary power which may make possible the execution of economic policy, but only purely executive powers can be delegated.[216] Thus, the Commission's Communication states that '[a]gencies cannot be given the power to adopt general regulatory measures. They are limited to taking individual decisions in specific areas where a defined technical expertise is required, under clearly and precisely defined conditions and without genuine discretionary power'.[217] Although some commentators have challenged the restrictive interpretation of the *Meroni* case,[218]

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213 Herwig Hofmann, 'Legislation, Delegation and Implementation under the Treaty of Lisbon: Typology Meets Reality' (2009) 15 *European Law Journal* 482, at 501; Merijn Chamon, 'EU Agencies between Meroni and Romano or the Devil and the Deep Blue Sea' (2011) 48 *Common Market Law Review* 1055, Sec. 4.

214 CJEU, Case 9/56, *Meroni v High Authority*, [1957–1958] ECR 133.

215 See, e.g., Niamh Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' (2010) 47 *Common Market Law Review* 1317, at 1347, 1352; Hans Van Meerten and A.T. Ottow, 'The Proposals for the European Supervisory Authorities: The Right (Legal) Way Forward?' (2010) 1 *Tijdschrift voor Financieel Recht* 5, at 11–14; P. Schammo, above note 131, Sec. 3.2 and 4.3; Niamh Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (2) Rules in Action' (2011) 12 *European Business Organization Law Review* 177, Sec. 3.2.2; Pierre Schammo, *EU Prospectus Law: New Perspectives on Regulatory Competition in Securities Markets* (Cambridge University Press, 2011), at 30–36; E. Wymeersch, 'The European Financial Supervisory Authorities or ESAs', above note 98, at 241, 245 and 255; Stuart Willey, 'The European System of Financial Supervision' in Michael C. Blair, George Alexander Walker and Stuart Willey (eds), *Financial Markets and Exchanges Law* (2nd edn, Oxford University Press, 2012), at 255.

216 CJEU, Case 9/56, above note 214, at 151–152.

217 European Commission, Communication from the Commission to the European Parliament and the Council: European agencies – The way forward, COM(2008) 135 final, March, 2008, at 5, available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0135:FIN:EN:PDF> (accessed June, 2017).

218 See, e.g., Edoardo Chiti, 'An Important Part of the EU's Institutional Machinery: Features, Problems and Perspectives of European Agencies' (2009) 46 *Common Market Law Review* 1395, at 1422–1424; Saskia Lavrijssen and Leigh Hancher, 'Networks on Track: From European Regulatory Networks to European Regulatory 'Network Agencies'' (2009) 36 *Legal Issues of Economic Integration* 23, at 23–55; Robert Schütze, ''Delegated' Legislation in the (new) European Union: A Constitutional Analysis' (2011) 74 *Modern Law Review* 661, at 674.

simply examining EU agencies by the *Meroni* doctrine would result in the conclusion that the current 'agencification'—the increased delegation of regulatory powers from the classical state's powers to specialised agencies[219]—is, *de facto*, in breach with this doctrine, as some have claimed.[220]

Given EU agencies are widely used now,[221] it is worth reviewing the *Meroni* doctrine here. As one commentator argues, EU 'agencies could be delegated discretionary powers provided that this is accompanied by reinforcement or re-balancing of the existing institutions'.[222] First, in accordance with the true meaning of the principle of institutional balance, the protective aspect in the *Meroni* doctrine seems to 'have been gradually lost' as other means of protection (such as, judicial review) appeared.[223] The purpose of the *Meroni* case could be preserved by 'a less rigid set of criteria' once the steering and control mechanisms are well established.[224] Second, the factual and legal contexts in which the agencies in the *Meroni* case and the current EU agencies operate are fundamentally different in nature: the former were bodies established under private law, whereas the latter are public bodies under the EU law.[225]

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219 The phenomenon is particularly well portrayed by Professor David Levi-Faur: see David Levi-Faur, 'Regulatory Networks and Regulatory Agencification: Towards A Single European Regulatory Space' (2011) 18 *Journal of European Public Policy* 810, at 810–829.

220 Giandomenico Majone, 'The Credibility Crisis of Community Regulation' (2000) 38 *Journal of Common Market Studies* 273, at 289–290; Herwig C. H. Hofmann and Alexander H. Türk, 'Policy implementation' in Alexander H. Türk (ed), *EU Administrative Governance* (Edward Elgar, 2006), at 89; Jarle Trondal, *An Emergent European Executive Order* (Oxford University Press, 2010), at 164.

221 According to the official database of the EU, there are more than thirty EU agencies. See further at: <http://europa.eu/about-eu/agencies/index_en.htm> (accessed June, 2017).

222 Ellen Vos, 'Reforming the European Commission: What Role to Play for EU Agencies?' (2000) 37 *Common Market Law Review* 1113, at 1124.

223 Jean-Paul Jacqué, 'The Principle of Institutional Balance' (2004) 41 *Common Market Law Review* 383, at 384.

224 Stefan Griller and Andreas Orator, 'Everything under Control? The "Way Forward" for European Agencies in the Footsteps of the Meroni Doctrine' (2010) 35 *European Law Review* 3, at 27–29.

225 Merijn Chamon, 'EU Agencies: Does the Meroni Doctrine Make Sense?' (2010) 17 *Maastricht Journal of European and Comparative Law* 281, at 297–298.

In fact, differing from the view of legal literature on the nature of discretion, political science literature provides a comparatively helpful way of viewing it—'the zone of discretion' consists of: (i) 'the sum of delegated powers (policy discretion) granted by the principal to the agent, minus' (ii) 'the sum of control instruments, available for use by the principal to shape (constrain) or annul (reverse) policy outcomes that emerge as a result of the agent's performance of set tasks'.[226] Therefore, the *Meroni* case ruling can be understood as 'the zone of discretion' shall be zero, regardless whether by means of (i) increasing the sum of control instruments, or (ii) decreasing the sum of delegated powers, or (iii) both.

Besides the *Meroni* case, another relevant case is *Romano v Institut national d'assurance maladie-invalidité* ('*Romano* case'),[227] in which the CJEU held that the Council of the European Economic Community ('EEC') could not delegate the power to adopt acts 'having the force of law' to agencies,[228] implying most likely the prohibition of delegation of legislative-like type of powers, rather than of powers to take legally-binding decisions in individual cases. Two points shall be noted: (i) the *Romano* case was a ruling under the Treaty establishing the European Economic Community ('the EEC Treaty');[229] and (ii) the delegatee in the *Romano* case was a body established under secondary EU law and not a body established by private law.[230] However, in the *Romano* case, the principle of institutional balance, which was considered in the *Meroni*

[226] Mark Thatcher and Alec Stone Sweet, 'Theory and Practice of Delegation to Non-Majoritarian Institutions' (2002) 25 *West European Politics* 1, at 5.
[227] CJEU, Case 98/80, *Romano v Institut national d'assurance maladie-invalidité*, [1981] ECR 1241.
[228] Ibid, para. 20.
[229] Ibid, para. 1.
[230] Ibid, para. 12.

case, was not relied by the CJEU as a support, and the CJEU formed its reasons of judgment by the range of the Commission's missions.[231] In the light of the aforementioned case-law limitations on the establishment of EU agencies, the legal grounds of ESMA's powers might be shaky and challengeable.

4.1.2. *United Kingdom v European Parliament* ('Case C-270/12')

On 22 January, 2014, an important constitutional judgement was made by the CJEU.[232] This case dealt with the legal limits of the proliferation of agencies within the EU and their powers imposed by the EU Treaties, and, in particular, with the *Meroni* and the *Romano* doctrines, as well as the new constitutional structure created with the Treaty of Lisbon with respect to delegated and implementing powers. It was held that implementing rights, including discretionary powers, may be conferred to EU agencies on the legal basis of Article 114 of the TFEU, but these have to be clear and precise, and delineated in conformity with the principle of institutional balance that are set by the 'updated' *Meroni* doctrine.[233] This ruling provides a clear instruction to EU agencies with discretionary powers (namely, ESMA here) after the Treaty of Lisbon.

In this case, the UK challenged the legality of Article 28 of the Short Selling Regulation,[234] which gives ESMA powers to prohibit or impose conditions on the entry

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[231] Damien Geradin, 'The Development of European Regulatory Agencies: What the EU Should Learn from American Experience' (2004) 11 *Columbia Journal of European Law* 1, footnote 54 of page 10.

[232] CJEU, Case C-270/12, *United Kingdom v European Parliament*, [2014] EU:C:2014:18. After this judgement published, the UK withdrew another similar case, Case C-507/13, *United Kingdom v Parliament and Council*, regarding the legitimacy of EBA's power: see 2015 OJ C146/31.

[233] René Repasi, *Assessment of the Judgment of the European Court of Justice in Case C-270/12, United Kingdom v Council and European Parliament: Impact of This Judgment on the Proposal of the SRM Regulation* (The Greens/EFA in the European Parliament, 2014), at 6–7, available at: <http://www.sven-giegold.de/wp-content/uploads/2014/01/Assessment-ECJ-Case-C-270-12-and-relevance-for-the-SRM1.pdf> (accessed June, 2017).

[234] For entire opinion of the UK in this case: see Elizabeth Howell, 'The European Court of Justice: Selling Us Short?' (2014) 11 *European Company & Financial Law Review* 454, at 464–472.

into short sales or similar transactions, and to require such persons to notify or publicise net short positions in conformity with Article 9.5 of ESMA Regulation.[235] The Court rejected all pleas of the UK, and dismissed the action of the UK, based on following reasons.

First of all, the CJEU observed that the bodies in question in the *Meroni* case were entities governed by private law, whereas ESMA is a EU entity created by EU law.[236] ESMA's discretion is limited by various conditions and criteria, and is required to examine a significant number of factors, so ESMA can take only certain types of measures and has duties to consult and notify various bodies.[237] The powers of intervention available to ESMA are also precisely delineated and amenable to judicial review.[238] The *Meroni* doctrine, thus, is satisfied here. In this sense, the *Meroni* case is not overruled, but 'restyled'.[239]

Second, the delegation of powers is not of a quasi-legislative nature, but rather fell within the ambit of the criteria of the *Meroni* judgment.[240] Even in strictly circumscribed circumstances, ESMA adopting measures of general application (which may include rules affecting any natural or legal person) is not at odds with the *Romano* doctrine, because this is envisaged and permitted by Articles 263 and 277 of the TFEU.[241]

Third, the delegation of powers to ESMA is valid even though it does not

235 See further in Section 3.3.2 above (p. 100).
236 CJEU, Case C-270/12, above note 232, para. 43.
237 Ibid, paras. 48–50.
238 Ibid, paras. 51–53.
239 Gianni Lo Schiavo, 'A Judicial Re-Thinking on the Delegation of Powers to European Agencies under EU Law? Comment on Case C-270/12 UK v. Council and Parliament' (2015) 16 *German Law Journal* 315, at 325.
240 CJEU, Case C-270/12, above note 232, para. 67.
241 Ibid, paras. 64–65.

correspond to any of the situations defined in Articles 290 and 291 of the TFEU.[242] These two Articles of the TFEU do not represent a closed system of delegation. While the EU Treaties do not contain any provision to the effect that powers may be conferred on a EU body, office or agency, a number of provisions in the TFEU, none the less, presuppose that such a possibility exists, such as, Articles 263, 265, 267 and 277.[243] Therefore, ESMA's powers conferred by the Short Selling Regulation cannot be regarded as undermining the rules governing the delegation of powers laid down in Articles 290 and 291 of the TFEU.[244]

Fourth, Article 114 of the TFEU is an appropriate legal basis of Article 28 of the Short Selling Regulation. This is based on a two-step examination. In the first step, due to the reasons that: (i) the range of 'measures for the approximation' of Article 114 'depends on the general context and the specific circumstances' (especially in fields with 'complex technical features') of the matter to be harmonised;[245] and (ii) the expression 'measures for the approximation' in Article 114 allows the legislature to establish a 'body responsible for the implementation of harmonisation' in particular,[246] if it requires 'specific professional and technical expertise', or 'the ability of such a body to respond swiftly and appropriately',[247] the CJEU confirmed that the system of intervention established by Article 28 of the Short Selling Regulation falls within the scope of Article

242 Ibid, para. 83.
243 Ibid, paras. 79–80.
244 Ibid, para. 86.
245 CJEU, Case C-66/04, *United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union*, [2005] ECR I-10553, para. 45.
246 CJEU, Case C-217/04, *United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union*, [2006] ECR I-3771, para. 44.
247 CJEU, Case C-270/12, above note 232, para. 105.

114 of the TFEU.[248] In the second step, given Article 28 of the Short Selling Regulation is in fact to improve the conditions for the establishment and functioning of the internal market in the financial field,[249] this harmonisation measure adopted by the EU legislature indeed is in line with the object of the internal market.[250]

Based on the ruling in this case, a liberal reading might suggest that the ESMA's constitutional basis is stabilised, and the *Meroni* doctrine is limited to finding a balance between the principle of institutional balance and the principle of internal market.[251] However, it might also be read more restrictively, namely, that operating powers of ESMA, as an EU agency, shall be restrained by the Commission with some conditions.[252] In fact, the '*Meroni*-light doctrine',[253] established by this case, does not end the debate, rather it adds a twist to what kind of discretion EU agencies have and should enjoy, in accordance with the principle of institutional balance.[254] As one commentator observed, the CJEU's silence on the issue of the institutional balance amounts to 'foolish judicial disregard for the vital need to ensure continuing financial

248 Ibid, para. 112.
249 Ibid, paras. 114–116.
250 Ibid, para. 113.
251 Jacques Pelkmans and Marta Simoncini, *Mellowing Meroni: How ESMA can help build the single market* (CEPS Commentary, 2014), at 5–6; János Kálmán, 'The ESMA Case and Its Impact on the Legal Framework of the European Agencies' in Csilla Gömbös, János Kálmán and Barna Arnold Keserű (eds), *Global and Local Legal Issues: From the Aspects of Law and Economy* (Universitas-Győr Nonprofit Ltd, 2014), at 215–217.
252 N. Moloney, *EU Securities and Financial Markets Regulation*, above note 132, at 1003.
253 Merijn Chamon, 'The Empowerment of Agencies under the Meroni Doctrine and Article 114 TFEU: Comment on United Kingdom v Parliament and Council (Short-selling) and the Proposed Single Resolution Mechanism' (2014) 39 *European Law Review* 380, at 394.
254 Miroslava Scholten and Marloes van Rijsbergen, 'The ESMA-Short Selling Case: Erecting a New Delegation Doctrine in the EU upon the Meroni-Romano Remnants' (2014) 41 *Legal Issues of Economic Integration* 389, at 401–404; E. Ferran, 'European Banking Union: Imperfect, But It Can Work', above note 38, para. 3.37; Chamon, ibid, at 394–395; Carl Fredrik Bergström, 'Shaping the New System for Delegation of Powers to EU Agencies: United Kingdom v. European Parliament and Council (Short Selling)' (2015) 52 *Common Market Law Review* 219, at 241–242; Merijn Chamon, 'The Institutional Balance, an Ill-Fated Principle of EU Law?' (2015) 21 *European Public Law* 371, at 389–390; Joana Mendes, 'Discretion, Care and Public Interests in the EU Administration: Probing the Limits of Law' (2016) 53 *Common Market Law Review* 419, at 419–451.

stability within Europe.'[255] Given this, the political sensitivities still remain after the decision of this case, and ESMA is likely to tread carefully when exercising its supervisory powers. In this sense, whether we adopt the liberal or the restrictive reading of this case, a more important issue is: how can we tackle the ambiguous competence and the institutional weaknesses of ESMA?

4.1.3. Ambiguous Competence of Investment Conduct Supervision

Given the sensitive place of ESMA, we have to ask whether the EU possesses powers of investment conduct supervision, so that the EU could delegate them to its agencies? In particular, the protection of local markets at the EU level is criticised by reason that NCAs are better placed to assess the risks to consumers posed by the relevant financial activities and to determine the best course of action.[256] Hardened and direct intervention powers at the EU level in the field of investment conduct supervision might represent a potential of inefficient centralisation and an establishment of a 'too distant interlocutor'.[257] The answer of this question, thus, should be examined carefully in the context of the principles of subsidiarity and proportionality within the EU Treaties (namely, TEU and TFEU).[258]

Furthermore, even though the competence of investment conduct supervision at the EU level could be justified, whether Article 114 of the TFEU that provides a treaty foundation of ESMA can be a legal basis for setting an agency in charge of the pan-EU

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[255] Michelle Everson, 'European Agencies: Barely Legal?' in Michelle Everson, C. Monda and E. Vos (eds), *EU Agencies in between Institutions and Member States* (Kluwer Law International, 2014), at 50.

[256] N. Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (2) Rules in Action', above note 215, at 203–204.

[257] Michelle Everson, *A Technology of Expertise: EU Financial Services Agencies* (LSE 'Europe in Question' Discussion Paper Series No 49/2012, 2012), at 22.

[258] P. Schammo, 'The European Securities and Markets Authority: Lifting the Veil on the Allocation of Powers', above note 131, at 1905–1906. See further in Section 2 of CHAPTER VI (pp. 262–271).

investment conduct supervision remains unclear in CJEU's case law.[259] Especially, in that case that a measure does not contribute to harmonisation, other possible articles (such as, Article 352) might be a preferable legal basis, because Article 114 is for a harmonisation measure only. Therefore, when establishing a EU agency in charge of pan-EU investment conduct supervision (or conferring this task to ESMA), the choice of a correct legal basis (the internal market clause of Article 114 or the flexibility clause of Article 352 of the TFEU) is likely to remain as a sensitive topic post-Lisbon in the context of agency governance.[260] In order to answer this question, we need to ask whether this centralisation of investment conduct supervision is really a measure of harmonisation?[261]

ESMA's tasks relevant to investment conduct supervision now include (i) 'ensuring' the taking of investment and other risks are appropriately supervised,[262] and (ii) 'enhancing' consumer protection.[263] According to Article 9 of the ESMA Regulation, entitled 'Tasks related to consumer protection and financial activities', ESMA could issue warnings in the context of consumer protection,[264] and could prohibit or restrict certain financial activities for overall financial stability and orderly functioning of markets.[265] However, to some extent, the banning power of Article 9.5 of the ESMA

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[259] For detailed discussion about the case law of Article 114 of the TFEU: see Stephen Weatherill, 'The Limits of Legislative Harmonization Ten Years after Tobacco Advertising: How the Court's Case Law has Become a Drafting Guide' (2011) 12 *German Law Journal* 827, at 829–843

[260] Isidora Maletić, 'Delegating Harmonization of the Internal Market: the Ruling in Case C-270/12 United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union (Short Selling Ban), Judgment of 22 January 2014' (2014) 33 *Yearbook of European Law* 501, at 511–517; E. Howell, above note 234, at 474; Merijn Chamon, *EU Agencies: Legal and Political Limits to the Transformation of the EU Administration* (Oxford University Press, 2016), at 136–153.

[261] See further in Section 4 of CHAPTER VI (pp. 275–300).

[262] Article 1.5(e) of ESMA Regulation.

[263] Article 1.5(f) of ESMA Regulation.

[264] Article 9.3 referring to Article 1.5(f).

[265] Article 9.5 and Recital 12 of ESMA Regulation.

Regulation lacks clarity, because it has two lines of reasoning: investor protection and financial stability.[266] The later from the 'macro' perspective would be in higher priority than the former from the 'micro' perspective, once they two have some conflicts in one case.[267] Articles 40.8 and 40.2(a) of MiFIR also mentions a possibility of 'significant investor protection concern' as the leeway for ESMA to directly prohibit or restrict investment conduct.[268] ESMA itself thereby confirmed this banning power as a last resort to 'ensuring' the interest of investors rather than overall financial stability and orderly functioning of markets.[269] This may be, implicitly, considered as ESMA's entering into the competence of investment conduct supervision. But, given the sensitivity and ambiguity of competence, it is critical that this power is exercised cautiously with a clear and transparent protocol.[270]

The issue of ambiguous competence is noted in the official documents of CMU. Within the Green Paper of CMU, the newly introduced ESMA's direct powers on 'investor protection' in MiFID II are confirmed, and it moves on to mention that ESMA's mandates in the area of consumer/investor protection 'could be clarified and enhanced where necessary',[271] followed by an important question that 'how can the

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[266] Eddy Wymeersch, 'Europe's New Financial Regulatory Bodies' (2011) 11 *Journal of Corporate Law Studies* 443, at 461; E. Wymeersch, 'The European Financial Supervisory Authorities or ESAs', above note 98, at 275.
[267] Jeroen JM Kremers and Dirk Schoenmaker, *Twin Peaks: Experiences in the Netherlands* (LSE Financial Markets Group Paper Series Special Paper 196, 2010), at 4–5.
[268] See also Recital 46 of MiFIR. For more details regarding the product intervention powers: see Section 3.3.2 above (pp. 102–103) and Section 3.3.8 of CHAPTER II (pp. 58–59).
[269] ESMA, ESMA Annual Report 2014, at 16–17, available at:
<https://www.esma.europa.eu/system/files_force/library/2015-934_annual_report_2014.pdf>
(accessed June, 2017).
See also European Commission, Report from the Commission to the European Parliament and the Council on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS), above note 203, at 8.
[270] IMF, above note 100, para. 92.
[271] European Commission, Green Paper: Building a Capital Markets Union, COM(2015) 63 final,

ESAs [ESMA] further contribute to ensuring consumer and investor protection?'.[272] From the context of this, although the Commission intends to carefully increase ESMA's direct powers in the future, the Commission admits that ESMA's competence of direct supervisory powers on investor protection is still unclear and controversial. Officially, there is no EU agency in charge of investment conduct supervision to date. NCAs still take centre stage of investment conduct supervision, and ESMA, for now, plays a merely supporting role.[273]

4.2. Institutional Weaknesses of ESMA

Even though ESMA's competence in supervising investment conduct could be found in the Treaties, the extant decision-making structure of ESMA might still be ill-suited to function as a competent supervisor. Two loopholes of ESMA's decision-making structure are noteworthy here: i.e., independence and accountability.[274]

First, in the absence of enough independence, the enforcement of an agency's powers may be, potentially, cumbersome, inefficient and likely to exacerbate tension between the EU institutions and ESMA.[275] As mentioned above,[276] ESMA's

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February, 2015, at 20, available at: <http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf> (accessed June, 2017). ('Green Paper of CMU')

[272] Ibid, Question 18.

[273] As admitted by the Commission, the investor/consumer protection issues are a shared competence of the EU and Member States, subject to the limits of the EU Treaty principles: see European Commission, ESA Consultation Paper, March, 2017, at 10, available at: <https://ec.europa.eu/info/sites/info/files/2017-esas-operations-consultation-document_en.pdf> (accessed June, 2017).

[274] Dariusz Adamski, 'The ESMA Doctrine: A Constitutional Revolution and the Economics of Delegation' (2014) 39 *European Law Review* 812, at 829–833; Phedon Nicolaides and Nadir Preziosi, 'Discretion and Accountability: An Economic Analysis of the ESMA Judgment and the Meroni Doctrine' (2014) 49 *Intereconomics* 279, at 287.

[275] N. Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (2) Rules in Action', above note 215, at 221–222.

[276] See Sections 3.2 and 3.3 above (pp. 88–105).

supervisory powers are largely controlled by the Commission, whose traditional role in financial markets is to initiate policies, propose legislation and adopt delegated rules, and, thus, has no enough experience with the operational business of supervision.[277] The involvement of the Commission would particularly undermine the effectiveness and independence of ESMA's tasks of supervision.[278] Moreover, the Council and the Parliament also have a limited role in relation to emergency situations.[279] The cumbersome interaction between EU institutions and agencies may cause an uncertainty in the functioning of ESMA.[280] There is, as a result, a need to 'de-politicise' ESMA's policy making,[281] and to focus on making the system work to achieve its real goals.

Second, ESMA is 'not directly democratically accountable',[282] but, for the well function of European agencies, the accountability is urgently needed.[283] Increasing the direct powers of ESMA should be balanced by appropriate accountability requirements, because it is a shift of supervisory powers from Member States to the EU.[284] Given that accountability and independence can and do co-exist,[285] it is possible to enhance

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277 See this at the website of European Commission, available at: <http://ec.europa.eu/finance/general-policy/policy/map_reform_en.htm> (accessed June, 2017).

278 N. Moloney, *EU Securities and Financial Markets Regulation*, above note 132, at 909–915.

279 Article 18.2 of ESMA Regulation. See further in Section 3.2.2 above (pp. 92–93).

280 N. Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (2) Rules in Action', above note 215, at 222–225.

281 Iris H-Y Chiu, 'Power and Accountability in the EU Financial Regulatory Architecture: Examining Inter-agency Relations, Agency Independence and Accountability' (2015) 8 *European Journal of Legal Studies* 67, at 76–84.

282 Rob Van Gestel, 'European Regulatory Agencies Adrift?' (2014) 21 *Maastricht Journal of European and Comparative Law* 188, at 196.

283 Deirdre Curtin and Renaud Dehousse, 'EU Agencies: Tipping the Balance? ' in Madalina Busuioc, Martijn Groenleer and Jarle Trondal (eds), *The Agency Phenomenon in the European Union: Emergence, Institutionalisation and Everyday Decision-making* (Manchester University Press, 2012), at 203–204.

284 Recital 55 of Council Regulation (EU) No 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, 2013 OJ L287/63. ('SSM Regulation') See also Niamh Moloney, 'Capital Markets Union: "Ever Closer Union" for the EU Financial System?' (2016) 41 *European Law Review* 307, at 422.

285 This is largely admitted by scholars: see, e.g., Eva Hüpkes, Marc Quintyn and Michael W. Taylor, 'The Accountability of Financial Sector Supervisors – Principles and Practice' (2005) 16 *European Business Law Review* 1575, at 1577–1581; Marc Quintyn and Michael W. Taylor, 'Robust Regulators and Their Political

ESMA's accountability and independence at the same time. The CJEU provides a good explanation:

> '[t]hat principle [of democracy] [...] requires that the administration be subject to the instructions of the government which is accountable to its parliament.[286] [...] That principle [of democracy] does not preclude the existence of public authorities outside the classic hierarchical administration and more or less independent of the government.[287] [...] In view of the foregoing, conferring a status independent of the general administration on the supervisory authorities responsible [...] does not in itself deprive those authorities of their democratic legitimacy.'[288]

Since that (i) democracy is a founding principle of EU law[289] and (ii) the democratic legitimation is an underpinning of the *Meroni* doctrine,[290] it remains to be seen to what extent the *Meroni*-light principles established by Case C-270/12 will need to accommodate democratic legitimacy concerns.[291]

Masters: Independence and Accountability in Theory' in Donato Masciandaro and Marc Quintyn (eds), *Designing Financial Supervision Institutions: Independence, Accountability and Governance* (Edward Elgar, 2007), at 14–20; Madalina Busuioc, 'Accountability, Control and Independence: The Case of European Agencies' (2009) 15 *European Law Journal* 599, at 614; Miroslava Scholten, ''Independent, Hence Unaccountable'? The Need for a Broader Debate on Accountability of the Executive' (2011) 4 *Review of European Administrative Law* 5, at 42–43. For a comprehensive analysis of independence and accountability: see Madalina Busuioc and Martijn Groenleer, 'The Theory and Practice of EU Agency Autonomy and Accountability: Early Day Expectations, Today's Realities and Future Perspectives' in Michelle Everson, Cosimo Monda and Ellen Vos (eds), *EU Agencies in between Institutions and Member States* (Kluwer Law International, 2014), at 201–228.

286 CJEU, Case C-518/07, *Commission v Germany*, [2010] ECR I-1885, para. 40.

287 Ibid, para. 42.

288 Ibid, para. 46.

289 Article 10 of the TEU.

290 Jens-Peter Schneider, 'A Common Framework for Decentralized EU Agencies and the Meroni Doctrine' (2009) 61 *Administrative Law Review* 29, at 37–40.

291 Heikki Marjosola, 'Bridging the Constitutional Gap in EU Executive Rule-Making: The Court of Justice Approves Legislative Conferral of Intervention Powers to European Securities Markets Authority' (2014) 10 *European Constitutional Law Review* 500, at 516; Miroslava Scholten and Marloes van Rijsbergen,

In the light of the foregoing discussion, in order to pay the price of constitutionality, ESMA has significant institutional weaknesses if in relation to its supervisory powers. Due to the acknowledgement of this, the Commission, on 21st March, 2017, published a consultation paper to review (i) the tasks and powers, (ii) the governance, (iii) the supervisory structure and (iv) funding of ESAs.[292] In terms of the independence issue, it is undeniable that a reform for keeping an arm's length between ESMA's operation and the EU institutions might offer two advantages: (i) increasing the transparency of the decision-making system; and (ii) reducing the risk of undue political interference on technical decisions.[293] Yet, it is not yet certain how the independence of ESMA could be achieved in balance with the constitutionality issue of EU agencies. Further clarification from the CJEU is needed for any further significant reform of ESMA's institutional arrangements. With regard to the accountability issue, some argue the democratic legitimacy issue might be resolved by enhanced political accountability within the decision-making structure of ESMA,[294] but a particular difficulty of political accountability in here is: there are different representations of interests at the EU level in the political triangle, so accountability mechanisms must be designed complexly to link oversights by the Commission, the Parliament and the Council.[295] Designing such a

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'The Limits of Agencification in the European Union' (2014) 15 *German Law Journal* 1223, at 1251–1254.

[292] European Commission, ESA Consultation Paper, March, 2017, available at: <https://ec.europa.eu/info/sites/info/files/2017-esas-operations-consultation-document_en.pdf> (accessed June, 2017).

[293] Renaud Dehousse, 'Misfits: EU Law and the Transformation of European Governance' in Christian Joerges and Renaud Dehousse (eds), *Good Governance in Europe's Integrated Market* (Oxford University Press, 2002), at 223.

[294] Anna Forgacs, 'The Regulatory Powers of Agencies in the United States and the European Union' (2015) 3 *European Networks Law and Regulation Quarterly* 11, at 23.

[295] Herwig C. H. Hofmann and Alessandro Morini, 'Constitutional Aspects of the Pluralisation of the EU Executive through "Agencification"' (2012) 37 *European Law Review* 419, at 435–436; see further in Madalina Busuioc, *European Agencies: Law and Practices of Accountability* (Oxford University Press, 2013), Ch. 6; and M. Chamon, *EU Agencies: Legal and Political Limits to the Transformation of the EU Administration*, above

balanced political accountability system is difficult too. Therefore, the judicial accountability might be a good focus of further reforms on ESMA. A feasible option, from the perspective of the judicial accountability, is to design a sound judicial guarantee of its decision-making procedures (for example, the judicial review of ESMA's decision-making process),[296] given the fact that the judicial review of ESMA's decisions has been established,[297]

4.3. Divergent Supervisory 'Cultures' of NCAs

Officially, the role of ESMA is just to improve a sound, effective and consistent level of supervision in the EU,[298] so NCAs continue to play a major role in supervising investment conduct. Under such circumstances, 'cultures' of supervision, which encompass a wider range of factors, are always divergent in Member States.[299] This is due to the reasons that (i) NCAs' powers retained by governments are different; (ii) ways of using powers by NCAs are contrasting; and (iii) the nature of state-society relations and the aims of governments are dissimilar.[300] In 2009, CESR first published a

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note 260, at 316–327.

[296] Marta Simoncini, 'The Erosion of the Meroni Doctrine: The Case of the European Aviation Safety Agency' (2015) 21 *European Public Law* 309, at 333–337; Ellen Vos, 'EU Agencies and Independence' in Dominique Ritleng (ed), *Independence and Legitimacy in the Institutional System of the European Union* (Oxford University Press, 2016), at 227.

[297] See, e.g., Article 61 of ESMA Regulation, Article 36e of CRA Regulation and Article 69 of EMIR, mention that Articles 263 and 265 of TFEU provide legal bases for the judicial review. For a comprehensive analysis in relation to this: See Merijn Chamon, 'EU Risk Regulators and EU Procedural Law' (2014) 5 *European Journal of Risk Regulation* 324, at 324–337; and M. Chamon, *EU Agencies: Legal and Political Limits to the Transformation of the EU Administration*, above note 260, at 327–367.

[298] Article 1.5(a) of ESMA Regulation.

[299] For example, in the field of EU energy regulation, differences and conflicts between national regulatory 'cultures' and EU legislation are identified and linked to implementation and market deficiencies: see Eberhard Bohne, 'Conflicts between National Regulatory Cultures and EU Energy Regulations' (2011) 19 *Utilities Policy* 255, at 255–269

[300] Mark Thatcher, 'Regulatory Agencies, the State and Markets: A Franco-British Comparison' (2007) 14 *Journal of European Public Policy* 1028, at 1043. See also D. Vitkova, 'Level 3 of the Lamfalussy Process: An Effective Tool for Achieving Pan-European Regulatory Consistency?' (2008) 2 *Law and Financial Markets Review* 158, at 168–170.

report about the supervision of MiFID I,[301] pointing out the inconsistent supervision of investment conduct among Member States.[302] In December, 2014, ESMA published a peer review report, including updated information of how NCAs implement MiFID I's investment conduct rules on providing 'fair, clear and not misleading information' to clients.[303] Albeit this report does not include some information requirements (such as, on-going reporting, post-sales communications and execution of orders) and does not cover the provision of personalised advice including portfolio management,[304] it proves that the tension of the home/host Member State divide still exists after the introduction of ESMA. Another peer review, on 'best execution' was published in February, 2015,[305] reveals that the level of implementation of the best execution provisions, as well the level of convergence in NCAs, are still relatively low.[306] Furthermore, the peer review on 'suitability' requirements, published in April, 2016, also shows varied methods that NCAs use to supervise the firms in their jurisdictions.[307] As Steven Maijoor, the Chair of ESMA, admits, the objective of supervisory convergence in the EU might be hard to

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301 CESR, Report on the mapping of supervisory powers, supervisory practices, administrative and criminal sanctioning regimes of Member States in relation to the Markets in Financial Instruments Directive (MiFID), CESR/08-220, February, 2009, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/09_058.pdf> (accessed June, 2017).

302 Ibid, paras. 132–137; Tables 2–4.

303 ESMA, MiFID – Conduct of Business, fair, clear and not misleading information: Peer View Report, ESMA/2014/1485, December, 2014, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1485_peer_review_report_-_mifid_-_conduct_of_business_fair_clear_and_not_misleading_information.pdf> (accessed June, 2017). ('ESMA Information Review')

304 Ibid, para. 3.

305 ESMA, Best Execution under MiFID: Peer View Report, ESMA/2015/494, February, 2015, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-494_peer_review_report_on_best_execution_under_mifid_0.pdf> (accessed June, 2017). ('ESMA Best Execution Review')

306 Ibid, para. 43.

307 ESMA, MiFID Suitability Requirements: Peer View Report, ESMA/2016/584, April, 2016, available at: <https://www.esma.europa.eu/sites/default/files/library/2016-584_suitability_peer_review_-_final_report.pdf> (accessed June, 2017). ('ESMA Suitability Review')

succeed entirely by the current network-based system, according to the effort made after the financial crisis.[308] Divergences of supervisory cultures, on top of different supervisory structures and conflicting supervisory biases, explain the real constraints on achieving this objective.[309]

4.3.1. Different Supervisory Structures

Although ESFS is built on a sector-based model,[310] NCAs have different supervisory structures. There are several sectoral schemes in Member States, with substantial differences in the powers granted to national supervisors: some Member States have an integrated single supervisor model (such as, Germany, Denmark and Austria); several Member States maintain a 'two-pillars' (such as, Croatia, Bulgaria and Luxembourg) or 'three-pillars' model (such as, Italy, Spain and Greece) following the institutional basis; and other Member States embrace the 'twin-peaks' model (such as, the UK, France and Netherlands).[311] More specifically, a specific unit or task force has been established in some Member States (for instance, in Bulgaria, Greece and Poland), while in most Member States (for instance, in the UK, France, Netherlands, Germany, Italy and Spain) more than one unit is involved in supervision of MiFID's provisions.[312] Obviously, supervisory powers of NCAs on investment conduct are not the same in

[308] Steven Maijoor, Capital Markets Union: Building Competitive, Efficient Capital Markets Trusted by Investors, ESMA/2014/1339, November, 2014, at 5, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1339_steven_maijoor_speech_at_growth_for_finance_brussels_6_november_2014.pdf> (accessed June, 2017).
[309] Yane Svetiev and Annetje Ottow, 'Financial Supervision in the Interstices Between Private and Public Law' (2014) 10 *European Review of Contract Law* 496, at 503–504.
[310] See further in Section 3.1 above (pp. 86–88).
[311] For a detailed analysis of Member States before the financial crisis: see E. Wymeersch, 'The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors', above note 66, sec. 6; see also Etay Katz (ed) *Financial Services Regulation in Europe* (2nd edn, Oxford University Press 2008).
[312] ESMA Best Execution Review, above note 305, para. 31.

different units in different Member States. These different arrangements, to a certain extent, are seem to reflect the different dimensions of the local markets,[313] but it is inevitable that inter-NCAs co-ordination issues could arise from the existence of a polarised field of supervisory architectures.[314]

In fact, despite the possibility that two NCAs are under the same sectoral scheme, they still differ greatly in terms of standards, procedures or even quality of supervisory practice. For example, even if the UK and Germany had similar single-supervisor-model NCAs (namely, FSA[315] and BaFin) during the period of 2002–04, empirical research still reveals large differences in the frequency and severity of administrative sanctions between the UK and Germany.[316] This is, particularly, the case in the practice of investment conduct supervision in the EU: first, there are divergent practices in relation to how NCAs take enforcement actions (whether pecuniary or non-pecuniary);[317] second, the type and frequency of periodic reporting by investment firms, the parameters triggering alerts to identify the risks and prioritise actions, the frequency and scope of on-site inspections and thematic reviews are significantly different between NCAs;[318] and, third, the different use of audit reports are detected, in particular certain

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313 ESMA Information Review, above note 303, para. 39.

314 Donato Masciandaro, Maria Nieto and Marc Quintyn, 'Financial Supervision in the EU: Is There Convergence in the National Architectures?' (2009) 17 *Journal of Financial Regulation and Compliance* 86, at 92–93.

315 Financial Services Authority ('FSA') was the former financial regulator in the UK, and it divided into two separate regulatory authorities, Financial Conduct Authority ('FCA') and Prudential Regulatory Authority ('PRA'), in 2013.

316 Howell E. Jackson, 'Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications' (2007) 24 *Yale Journal on Regulation* 253, at 281–286.

317 ESMA Best Execution Review, above note 305, paras. 143–147; ESMA Suitability Review, above note 307, para. 76.

318 ESMA Information Review, above note 303, para. 79; ESMA Best Execution Review, above note 305, para. 35; ESMA Suitability Review, above note 307, paras. 39–46.

NCAs use their supervision reports prepared by external auditors.[319] In the light of the different supervisory structures between Member States, it may be nearly impossible to require NCAs to have the same reaction and take the same measures when facing the same situation.

4.3.2. Conflicting Supervisory Biases

In extreme cases, even if the supervisory structures of NCAs are identical, there is no guarantee that NCAs' behaviour will be exactly the same. This is because NCAs, which are operated by human beings, having their own 'preferences' or even 'biases'. Specifically, three typical biases have been identified in the internal market in the wake of financial crisis: namely, (i) the national bias, (ii) the home Member State's bias, and (iii) the host Member State's bias.

First, due to the national bias, pan-EU risks are not considered sufficiently by NCAs. Negative externalities will not be taken into account sufficiently if NCAs are accountable only to their own jurisdiction in the EU's cross-border market.[320] This is because 'national views rather than the EU-wide interests' dominate the decision making process of NCAs.[321] Overlapping and even conflicting lines between the national accountability and the 'European accountability' exist as an intrinsic handicap of NCAs in dealing with cross-border issues.[322] From this viewpoint, ESMA's

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[319] ESMA Information Review, above note 303, para. 85; ESMA Best Execution Review, above note 305, para. 36; ESMA Suitability Review, above note 307, paras. 89 and 96.

[320] Stéphanie Stolz, *Banking Supervision in Integrated Financial Markets: Implications for the EU* (CESifo Working Paper No 812, 2002), at 6–17; Dirk Schoenmaker and Sander Oosterloo, 'Financial Supervision in an Integrating Europe: Measuring Cross-Border Externalities' (2005) 8 *International Finance* 1, at 5–6.

[321] European Commission, Report from the Commission to the European Parliament and the Council on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS), above note 203, at 9.

[322] Lorenzo Bini Smaghi, 'Independence and Accountability in Supervision: General Principles and European Setting' in Donato Masciandaro and Marc Quintyn (eds), *Designing Financial Supervision*

independence requirement on the Board of Supervisors requiring a sole consideration of the EU's interests[323] may be seem at odds with the role of NCAs: it is almost impossible to require the Members of the Board of Supervisors (i.e. NCAs who are first and only accountable at the national level) to act in the European interests when making co-decision in ESMA.[324] Under such a condition, ESMA's capability may also be limited by the national biases, because ESMA's information and part of its funding are obtained from NCAs.[325] Indeed, the national bias might be serious in cross-border transactions. However, what we have to ask is the definition of 'public interest'[326] of the EU, which is an obscure and controversial question. There is no guarantee that European public interests could be judged by ESMA easily either.[327] Therefore, an option that may be considered is either: (i) to establish a rotation system of the Board of Supervisors, or (ii) to compose it with independent members that are not affiliated to Member States.[328]

Second, NCAs of home Member States, because of the home Member State's bias, seldom take account of host Member States' interests. Since they do not bear the costs of a crisis in other countries, NCAs of home Member State have few incentives to fully

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Institutions: Independence, Accountability and Governance (Edward Elgar, 2007), at 59.

323 Article 42 of ESMA Regulation.

324 E. Wymeersch, 'The European Financial Supervisory Authorities or ESAs', above note 98, at 241–242, 298.

325 Donato Masciandaro, Maria J. Nieto and Marc Quintyn, 'Exploring Governance of the New European Banking Authority—A Case for Harmonization?' (2011) 7 *Journal of Financial Stability* 204, at 210; María J Nieto, 'Regulatory Coordination in the Banking Union: The Role of National Authorities' in Luis M. Hinojosa-Martínez and José María Beneyto (eds), *European Banking Union: The New Regime* (Kluwer Law International, 2015), at 83–84.

326 Article 1.5 of ESMA Regulation.

327 P. Schammo, 'The European Securities and Markets Authority: Lifting the Veil on the Allocation of Powers', above note 131, at 1904–1905.

328 Georgina Tsagas, 'The Regulatory Powers of the European Supervisory Authorities: Constitutional, Political and Functional Considerations' in Mads Andenas and Gudula Deipenbrock (eds), *Regulating and Supervising European Financial Markets: More Risks than Achievements* (Springer, 2016), at 133.

internalise host Member States' stability risks.[329] Therefore, a country-by-country system will create a series of supervisory gaps in the European cross-border market—namely, 'scarce supervisory resources are expended in a discriminatory way, with disproportionately less being devoted to extraterritorial supervision'.[330] This is a reasonable outcome that can be expected, given the political accountability and technical difficulties of home Member States' supervisors in the current system.

Third, even though the NCAs of home Member States are willing to supervise cross-border transactions, co-operation between home and host Member States may still be constrained by the host Member State's bias. This is because NCAs of host Member States, more or less, have to respond to national interests in their countries, and this might induce them to adopt a protectionist stance.[331] Provided that the NCAs of host Member States do not have the ultimate responsibility of supervising these cross-border firms, they might be reluctant to provide assistance that home Member States need.[332] One even worse possibility is: the NCAs of host Member States may have incentives to misreport information in order to obtain a preferable outcome during the crisis.[333] Given the co-existence of the conflicting supervisory biases between Member States, it

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[329] Dirk Schoenmaker and Sander Oosterloo, 'Cross-Border Issues in European Financial Supervision' in David Mayes and Geoffrey Wood (eds), *The Structure of Financial Regulation* (Routledge, 2005), at 279; Katharina Pistor, 'Host's Dilemma: Rethinking EU Banking Regulation in Light of the Global Crisis' in Stefan Grundmann, Brigitte Haar and Hanno Merkt (eds), *Festschrift für Klaus J Hopt zum 70: Unternehmen, Markt und Verantwortung*, vol 1 (De Gruyter, 2010), at 2346.

[330] Donald C Langevoort, 'Structuring Securities Regulation in the European Union: Lessons from the US experience' in Guido Ferrarini and Eddy Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, The MiFID and Beyond* (Oxford University Press, 2006), at 487.

[331] Guido Ferrarini, 'Securities Regulation and the Rise of Pan-European Securities Markets: An Overview' in Guido Ferrarini, Klaus J. Hopt and Eddy Wymeersch (eds), *Capital Markets in the Age of the Euro: Cross-border Transactions, Listed Companies and Regulation* (Kluwer Law International, 2002), at 249.

[332] David Mayes and Jukka Vesala, 'On the Problems of Home Country Control' (2003) 7 *European Economic and Political Issues* 111, at 125.

[333] Cornelia Holthausen and Thomas Rønde, *Cooperation in International Banking Supervision* (ECB Working Paper No 316, 2004), at 5.

is again proved the unattainable goal of the comprehensive supervisory convergence.

4.4. Inevitability of A Single Investment Conduct Supervisor?

Given the aforementioned challenges, the current supervisory system in the EU is often condemned by big participants (cross-border investment firms) as a cause of considerable costs and inefficiency, followed by a plea for building a single supervisor with real powers at the EU level in order to harmonise different national supervisory practices.[334] This voice, in fact, gets even louder after the launch of CMU.[335] However, as the Commission admitted:

> '[s]ome of these divergences [of national approaches and practices] are warranted to accommodate national specificities, while others are rather due to different interpretations of the underlying principles, leading to situations where rules overlap or contain inconsistent legal requirements.'[336]

Not all Member States appreciate EU agencies in the same manner, so more competences transferred to the EU level might even disturb the network and balance of powers between the EU and Member States.[337] Here, imposing a uniform conduct

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[334] Luca Enriques and Matteo Gatti, 'Is There a Uniform EU Securities Law after the Financial Services Action Plan' (2008) 14 *Stanford Journal of Law, Business & Finance* 43, at 81.

[335] See, e.g., Patrick Kenadjian, 'The European Capital Markets Union: How Viable A Goal?' in Andreas Dombret and Patrick Kenadjian (eds), *The European Capital Markets Union: A Viable Concept and A Real Goal?* (De Gruyter, 2015), at 120; Kaloyan Simeonov, 'EU Capital Markets Initiatives for Better Financing SMEs' (2015) 16 *On-line Journal Modelling the New Europe* 43, at 48; Nicolas Véron and Guntram B. Wolff, 'Capital Markets Union: A Vision for the Long Term' (2016) 2 *Journal of Financial Regulation* 130, at 17–19.

[336] European Commission, Commission Staff Working Document: Economic Analysis accompanying the document of Action Plan on Building a Capital Markets Union, SWD(2015) 183 final, September, 2015, at 83, available at: <http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-economic-analysis_en.pdf> (accessed June, 2017).

[337] Michael Kaeding and Esther Versluis, 'EU Agencies as a Solution to Pan-European Implementation Problems' in Michelle Everson, Cosimo Monda and Ellen Vos (eds), *European Agencies in between Institutions and Member States* (Kluwer Law International, 2014), at 83–84 and 86.

supervisory strategy at the EU level may seriously jeopardise the regulatory objective (namely, ensuring a high level of investor protection) pursued by the MiFID regime.[338] Divergences of national supervisory practices do not necessarily mean that the current network-based system of investment conduct supervision in the EU is either bad or good.[339]

Indeed, any big European fix in the CMU might be contentious.[340] For example, the issue about different levels of investor protection caused by divergent national supervisory cultures is considered by the Green Paper of CMU.[341] A relevant question, 'Do you think that the powers of the ESAs [ESMA] to ensure consistent supervision are sufficient? What additional measures relating to EU level supervision would materially contribute to developing a capital markets union?',[342] is then asked. In response, most governments and industry associations consider ESMA's current powers as sufficient,[343] so ESMA, in the early stages of CMU, will need to fully use its current tools with a strategy to strengthen supervisory convergence and consistent implementation of the EU law.[344] On the contrary, in the Commission's CMU communication, it admits that, in some areas where it can bring benefits in the CMU, further reforms to reinforce 'the

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338 Y. Svetiev and A. Ottow, above note 309, at 540.
339 N. Moloney, 'Banking Union and the Implications for Financial Market Governance in the EU: Convergence or Divergence?', above note 38, paras. 16.21–16.24.
340 Owen Sanderson, 'Capital Markets Union Could Fly as Commission Sets Out 'Realistic' Vision' *Euroweek* (23 February, 2015).
341 Green Paper of CMU, above note 271, at 22.
342 Ibid, Question 25.
343 European Commission, Commission Staff Working Document: Feedback Statement on the Green Paper "Building a Capital Markets Union", above note 336, at 53.
344 European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Action Plan on Building a Capital Markets Union, COM(2015) 468 final, September, 2015, at 26–27, available at: <http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf> (accessed June, 2017). ('Action Plan of CMU')

European dimension of supervision' will be needed.[345] The European Investment Bank ('EIB') and the ECB both suggest that a single capital markets supervisor should be established in the long term.[346] The five Presidents' Report also indicates that the CMU should ultimately lead to a single European capital markets supervisor.[347] In this sense, the plan of CMU perhaps is a first political step towards the establishment of a single supervisor in the European capital markets, after the successful precedent of building the SSM within the EBU.[348] However, what we have to ask is whether the CMU will really make a single supervisor in charge of investment conduct inevitable, as the SSM within the EBU?

5. Concluding Remarks

This chapter has engaged in a deep analysis of the extant EU supervisory system and relative issues of investment conduct supervision. Given the tension caused by the home/host divide of supervisory competence between NCAs in cross-border transactions, ESMA was set up as a supervisor of supervisors and empowered with some hard powers and direct supervisory powers. It is also important to emphasise that

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345 Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: Capital Markets Union - Accelerating Reform, COM(2016) 601 final, September, 2016, at 6, available at: <http://ec.europa.eu/finance/capital-markets-union/docs/20160914-com-2016-601_en.pdf> (accessed June, 2017).

346 European Commission, Commission Staff Working Document: Feedback Statement on the Green Paper "Building a Capital Markets Union", above note 336, at 53.

347 European Commission, Completing Europe's Economic and Monetary Union (reported by Jean-Claude Juncker, Donald Tusk, Jeroen Dijsselbloem, Mario Draghi & Martin Schulz), June, 2015, at 12, available at: <http://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf> (accessed June, 2017). ('Five Presidents' Report')

348 See European Commission, ESA Consultation Paper, March, 2017, at 21–22 and Question 28, available at: <https://ec.europa.eu/info/sites/info/files/2017-esas-operations-consultation-document_en.pdf> (accessed June, 2017).

more and more direct supervisory powers are conferred to ESMA, whether by sectoral legislation and ESMA Regulation. Nevertheless, as an EU agency, ESMA's powers are restricted by the EU Treaties, not to mention the intrinsic institutional weaknesses of ESMA. To date, officially, the competence of investment conduct supervision in the EU is still left to NCAs, and the divergent supervisory cultures cause inconsistent and different practice among Member States. 'Big' firms often condemn that the divergent supervisory cultures bring significant costs in cross-border transactions, followed by a plea for building a single supervisor in charge of investment conduct supervision in the CMU.

However, we should not blindly believe there is a standard path towards the European Single Market, i.e., starting from the establishment of a Single Passport, bypassing the setting up of a Single Rulebook and reaching the installation of a single supervisor at the end. Although the Single Passport and the Single Rulebook are in place in the European investment conduct regulation,[349] there is no model answer after such development. The single supervisor is not an inevitable next step in the CMU. In other words, what we have to ask is whether a planned reform, in this case the installation of a single supervisor in charge of investment conduct supervision in the CMU, will really bring a better outcome than the current system? The EU should consider carefully about the options between building up a centralised single supervisor and upgrading the current system to meet the expanded needs of a true CMU.[350]

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349 See further in Sections 2 and 3 of CHAPTER II (pp. 17–61).

350 As the Commission said, financial integration will need to be accompanied by (1) increased focus on achieving supervisory convergence, or (2) necessary adjustments to strengthen the supervisory powers at the EU level. See European Commission, Public Consultation on The Capital Markets Union Mid-Term Review, January, 2017), at 18, available at:

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<https://ec.europa.eu/info/sites/info/files/consultation-document_en_0.pdf> (accessed June, 2017).

CHAPTER IV

TRANSACTION COST APPROACH OF INVESTMENT CONDUCT GOVERNANCE

'Economists studying business and industrial organization have long recognised the inadequacy of the neoclassical view of the firm and have developed richer paradigms and models based on the concepts of various kinds of transaction costs. Policy analysis also stands to benefit from such an approach, opening the black box and examining the actual workings of the mechanism inside.'[1]

1. Introduction

In order to examine whether the installation of a single supervisor in charge of investment conduct supervision in the CMU will really bring a better outcome than the current network-based system, it is necessary to build consolidated theoretical foundations for the institutional comparison. Given this, a 'transaction cost' approach to investment conduct governance derived from the findings of the TCE, will be explored in detail in this chapter. In essence, the TCE has two major propositions: (i) institutional governance matters in relation to the economic structure; and (ii) the determinants of institutional governance can be explained and understood by the tools of economic theory.[2] By incorporating a broader sense of institutional governance within the TCE, market discipline, administrative regulation and private law systems all

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[1] Avinash K. Dixit, *The Making of Economic Policy: A Transaction-Cost Politics Perspective* (The MIT Press, 1996), at 9.

[2] R. C. O. Matthews, 'The Economics of Institutions and the Sources of Growth' (1986) 96 *Economic Journal* 903, at 903.

become one type of 'investment conduct governance'.[3] Also, based on the organisational failures framework set by the TCE, no type of investment conduct governance is flawless, namely, the impossibility of a zero-transaction-cost world.[4] The purpose of this chapter, thus, is threefold: first, to highlight the strengths and shortcomings of the different types of investment conduct governance; second, to establish a model for selecting optimum investment conduct governance; and, third, to explain how investment conduct governance changes and persists. In the light of this, the research question could be answered by an institutional comparison on the basis of the transaction cost approach.

The remainder of this chapter is in five sections. Section 2 provides a comprehensive literature review of the transaction cost approach of governance, in respect of its history, framework, methodology and the limits and implications of this approach. Section 3 moves on to apply the transaction cost approach to examining three major types of investment conduct governance (i.e., market discipline, administrative regulation and private law systems). The theoretic frameworks of institutional selection and of institutional change in investment conduct governance are then established in Sections 4 and 5 respectively. The final section, Section 6, summarises the findings of this chapter which will be applied to the institutional comparison in the following chapters.

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[3] See further in Section 2.3 below (pp. 142–144).

[4] See further in Section 2.2 below (pp. 137–142).

2. Transaction Cost Approach of Governance

2.1. Emergence of Transaction Cost Economics

Ronald Coase, who was awarded the Nobel Prize in Economics in 1991, argues that the operation of a market to allocate resources costs 'something', and certain costs of markets are saved by forming an organisation and allowing some authorities to direct the resources[5]—in particular, some transactions are better managed via a hierarchy within a firm, rather than by a market, because the firm could reduce the costs of using the price mechanism of the market greatly.[6] However, since the costs of organising additional transactions within the firm may be higher than the costs of the market mechanism, a balanced point must be reached where the costs of organising an extra transaction within the firm becomes equal to the costs of carrying out the same transaction by means of an exchange on the open market, or the costs of organising in another firm.[7] Due to this landmark framework, the term 'transaction cost' is frequently thought to have been coined by Coase,[8] who indicates that transaction costs are the sole barrier to economic efficiency.[9] The TCE then becomes most widely known as one important theory of the New Institutional Economics ('NIE'),[10] and is systematised by

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[5] Ronald H. Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386, at 392.
[6] Ibid, at 390–391.
[7] Ibid, at 396–397.
[8] Ibid, at 390: 'there is a cost of using the price mechanism'; Ronald H. Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1, at 15: '[i]n order to carry out a market transaction it is necessary to discover who it is that one deals with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up a contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and soon.'
[9] Ronald H. Coase, *The Firm, The Market, and The Law* (University of Chicago Press, 1988), at 157–158, 174–179.
[10] The term 'NIE' was coined by Oliver Williamson in 1975. Professor Williamson defines that NIE has two common consensuses: (i) the current 'micro-theory [in economics] […] operates at too high a level of abstraction to permit many microeconomic phenomena to be addressed in an uncontrived way'; and (ii) 'the study of "transactions" […] is a core matter and deserves renewed attention'. See Oliver E.

Oliver Williamson (a Nobel Prize laureate in Economics in 2009).[11]

In the TCE, transactions are the basic and ultimate unit of analysis,[12] where a transaction is said to occur 'when a good or service is transferred across a technologically separable interface'.[13] Then, what are transaction costs? Since there is no precise answer of this question, the 'bad name' of 'transaction costs' is criticised as a theoretical device that 'almost anything can be rationalised by invoking suitably specified transaction costs'.[14] Williamson also admits that the broad, elastic and plausible concept of transaction costs is a 'grave problem'.[15] However, there is a strong response to this critique: although a clear definition of transaction costs does not exist, neither are the 'costs of production' in the Neoclassical Economics well defined.[16] Kenneth Arrow, the youngest laureate of the Nobel Prize in Economics, defines 'transaction costs' as 'costs of running the economic system'.[17] This definition includes the costs 'establishing' and 'maintaining' property rights which are the ability to freely exercise a choice over a good or service.[18] 'Anything that impedes the specification, monitoring, or enforcement of an economic transaction is a transaction cost'.[19] Generally, scholars of the NIE apply a

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Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (Free Press, 1975), footnote 1 of page 1.

11 See Oliver E. Williamson, *The Economic Institutions of Capitalism* (Free Press, 1985).

12 John Rogers Commons, *Institutional Economics: Its Place in Political Economy* (The Macmillan Company, 1934), at 4.

13 Oliver E. Williamson, 'The Economics of Organization: The Transaction Cost Approach' (1981) 87 *American Journal of Sociology* 548, at 552.

14 Stanley Fischer, 'Long-Term Contracting, Sticky Prices, and Monetary Policy: A Comment' (1977) 3 *Journal of Monetary Economics* 317, footnote 5 of page 322.

15 Oliver E. Williamson, 'Hierarchies, Markets and Power in the Economy: An Economic Perspective' (1995) 4 *Industrial and Corporate Change* 21, at 33.

16 Eggertsson Thráinn, *Economic Behavior and Institutions* (Cambridge University Press, 1990), at 14.

17 Kenneth J. Arrow, 'The Organization of Economic Activity: Issues Pertinent to the Choice of Market versus Nonmarket Allocation' in Joint Economic Committee (ed), *The Analysis and Evaluation of Public Expenditure: the PPB System*, vol 1 (US Washington DC: Government Printing Office, 1969), at 48.

18 Douglas W. Allen, 'What are Transaction Costs?' (1991) 14 *Research in Law and Economics* 1, at 1–18.

19 A. K. Dixit, above note 1, at 38.

comprehensive definition of transaction costs. For example, Barzel defines 'transaction costs' as 'the costs associated with the transfer, capture and protection of rights'.[20] Furubotn and Richter mention that 'transaction costs include the costs of resources utilised for the creation, maintenance, use, change, and so on of institutions and organisations.'[21] This is because simply analysing the costs involved with market transactions will underestimate the total transaction costs, in particular government (or even legal systems) is also involved in definition or reallocation of property rights that enables private trade.[22] Therefore, transaction costs have a broad nature and this nature would depend on the institutions of a country—the legal system (property rights and their enforcement), the political system, the educational system, and the culture.[23] Albeit this broad definition may make it difficult to measure transaction costs precisely, it is still possible to measure them by a qualitative way if we know what would cause transaction costs.

2.2. From Market Failures, Government Failures to Organisational Failures

Traditionally, in case of 'market failures', where Adam Smith's 'invisible hand'[24] does not work, the government should intervene in the market as the 'helping hand' for

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[20] Yoram Barzel, *Economic Analysis of Property Rights* (2nd edn, Combridge University Press, 1997), at 4.
[21] Eirik Grundtvig Furubotn and Rudolf Richter, *Institutions and Economic Theory: the Contribution of the New Institutional Economics* (2nd edn, University of Michigan Press, 2005), at 48.
[22] Laura McCann et al, 'Transaction Cost Measurement for Evaluating Environmental Policies' (2005) 52 *Ecological Economics* 527, at 530
[23] Ronald H. Coase, 'The Task of the Society' (1999) 2 *ISNIE Newsletter* 1, at 4.
[24] This term was coined by Adam Smith in *The Wealth of Nations* (originally published in 1776), at 293. According to Smith, markets work automatically, as it directed by an invisible hand, to promote economic efficiency and maximise individual welfare of participants in a market economy: see Adam Smith, *An Inquiry into the Nature and Causes of The Wealth of Nations* (Harriman House, 2007), at xiv–xvi.

'public interest'.[25] The normative theories of regulation are principally based on the welfare economics of Pigou.[26] Although regulation can never satisfy the Pareto test[27] (which 'is a "no-one-is-harmed" situation where all parties benefit, or none are harmed, by a reallocation of resources, goods, assets, or a change in the law'[28]), there is a good chance that there will be the Kaldor-Hicks efficiency,[29] as a 'second best'[30] solution—a new state under regulation is better than the current state without regulation, if those who gain from the new state gain enough to compensate those who lose.[31] It is important to note the normative view on regulation has two important assumptions: (i) there are significant market failures, and (ii) the government has incentives and capabilities to ameliorate these market failures.[32] However, these two assumptions are strongly debatable.

First, if transaction costs go to zero, resource allocation will approach efficiency automatically.[33] Therefore, as Arrow observed, 'market failure is not absolute; it is better to consider a broader category, that of transaction costs, which in general impede

[25] Andrei Shleifer, 'Understanding Regulation' (2005) 11 *European Financial Management* 439, at 440.
[26] See generally Arthur C. Pigou, *The Economics of Welfare* (4th edn, London: Macmillan, 1932).
[27] See further in James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (University of Michigan Press, 1965), paras. 3.7.12–3.7.19; 3.12.2–3.12.6.
[28] Francesco Parisi, *The Language of Law and Economics: A Dictionary* (Cambridge University Press, 2013), at 215.
[29] Kaldor Nicholas, 'Welfare Propositions of Economics and Interpersonal Comparisons of Utility' (1939) 49 *The Economic Journal* 549, at 549–552; J. R. Hicks, 'The Foundations of Welfare Economics' (1939) 49 *The Economic Journal* 696, at 696–712.
[30] R. G. Lipsey and Kelvin Lancaster, 'The General Theory of Second Best' (1956) 24 *The Review of Economic Studies* 11, at 11–17.
[31] Herbert Hovenkamp, 'Legislation, Well-Being, and Public Choice' (1990) 57 *The University of Chicago Law Review* 63, at 64–67.
[32] Roger G. Noll, 'Economic Perspectives on the Politics of Regulation' in Richard Schmalensee and Robert D. Willig (eds), *Handbook of Industrial Organization*, vol 2 (North-Holland, 1989), at 1255–1262. Dr. Hantke-Domas provides a very clear diagram to clarify the normative theories of regulation: see Michael Hantke-Domas, 'The Public Interest Theory of Regulation: Non-Existence or Misinterpretation?' 15 *European Journal of Law and Economics* 165, at 189.
[33] George Joseph Stigler, *The Theory of Price* (4th edn, Macmillan, 1987), at 117–120.

and in particular cases completely block the formation of markets'.[34] Market failures should be seen as 'failures only in a limited sense that they involve transaction costs' and 'can be attenuated by substituting organisations for market exchange',[35] where 'the existence of the market is no longer worthwhile'.[36] In this sense, every 'market failure' just provides a profit opportunity to choose a governance mechanism that minimises transaction costs.[37] Second, principal-agent problems also exist between regulators and taxpayers,[38] while the normative theories seldom consider this issue.[39] The positive theories of regulation strongly challenge the assumption that public agencies are benevolent and have incentives and capabilities to cure market failures.[40] As Coase mentioned, 'we find a category "market failure" but no category "government failure"',[41] which represents 'a concept referring to substantial imperfection in government performance'.[42] Government is the same as a market—it may fail (and often does).[43]

Given this, the TCE applies a new framework to understand the causes of

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34 K. J. Arrow, above note 17, at 48.

35 Oliver E. Williamson, 'The Vertical Integration of Production: Market Failure Considerations' (1971) 61 *The American Economic Review* 112, at 114.

36 K. J. Arrow, above note 17, at 70.

37 D. Bruce Johnsen, *Transaction Cost-Benefit Analysis, with Applications to Financial Regulation* (George Mason University School of Law Working Papers, 2013), at 4.

38 R. G. Noll, above note 32, at 1277–1281.

39 Richard J. Herring and Reinhard H. Schmidt, 'The Economic Rationale for Financial Regulation Reconsidered: An Essay in Honour of David Llewellyn' in Christopher J. Green, Eric J. Pentecost and Thomas G. Weyman-Jones (eds), *The Financial Crisis and the Regulation of Finance* (Edward Elgar, 2011), at 70.

40 See further in Section 3.2.2 below (pp. 155–157). For general information with regard to the debate between the normative and positive views of regulation: see Anthony Ogus, *Regulation: Legal Form and Economic Theory* (Hart Publishing 2004), part II; W. Kip Viscusi, Joseph Emmett Harrington and John M. Vernon, *Economics of Regulation and Antitrust* (4th edn, The MIT Press, 2005), at 378–379; Cento Veljanovski, 'Economic Approaches to Regulation' in Robert Baldwin, Martin Cave and Martin Lodge (eds), *The Oxford Handbook of Regulation* (Oxford University Press, 2010), at 17–19.

41 Ronald H. Coase, 'The Regulated Industries—Discussion' (1964) 54 *The American Economic Review* 192, at 195.

42 Barak Orbach, 'What Is Government Failure?' (2012) 30 *Yale Journal on Regulation Online* 44, at 56.

43 Professor Schuck gives a comprehensive analysis to explain why 'government failure' is so often: see Peter H. Schuck, *Why Government Fails So Often: And How It Can Do Better* (Princeton University Press 2014), Part 2.

transaction costs, namely, 'organisational failures'.[44] Since organisations include political bodies (political parties, regulatory agencies, etc.), economic bodies (firms, trade unions, etc.), social bodies (churches, associations, etc.), educational bodies (schools, universities, etc.),[45] organisational failures are not peculiar to market, firms, regulatory agencies or government. As shown by Figure IV-1 below, the organisational failures occur when environmental factors and human factors interact, corresponding to the objective and subjective dimensions of costs respectively.[46]

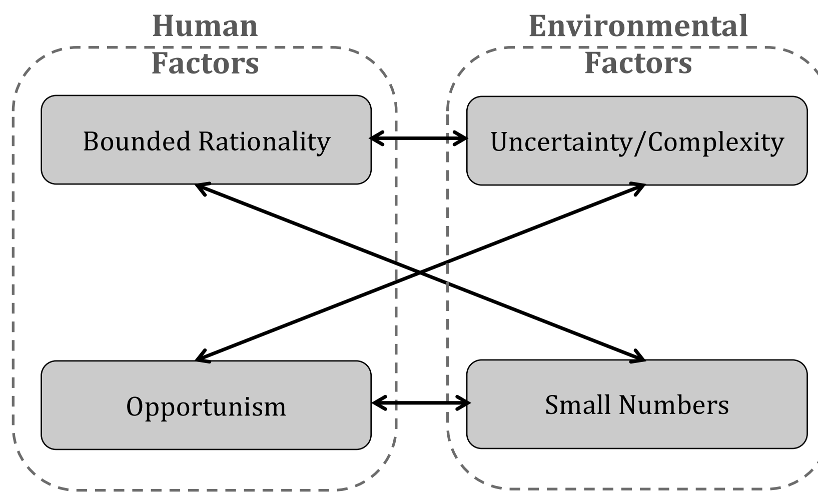

Figure IV-1: Organisational Failures Framework[47]

'Uncertainty/complexity' and 'small numbers' are two environmental factors of the organisational failures framework. A situation with uncertainty/complexity is very costly, perhaps impossible, to describe the complete decision tree.[48] A famous issue in the

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[44] O. E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications*, above note 10, Ch. 2.
[45] Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge University Press, 1990), at 5.
[46] James M. Buchanan, *Cost and Choice: An Inquiry in Economic Theory* (Markham Publishing, 1969), at 47–50.
[47] O. E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications*, above note 10, at 40.
[48] Ibid, at 23. There is a slight difference between uncertainty and complexity: in an uncertain condition, people would make final decision on the basis of limited information, while people would try to acquire more acknowledge before a final decision is made in a complex condition. See further in Sushil Bikhchandani, Jack Hirshleifer and John G. Riley, *The Analytics of Uncertainty and Information* (2nd edn, Cambridge University Press, 2015), at 2.

Neoclassical Economics, information asymmetries, focuses on this factor.[49] In terms of the small-number issue, it is 'fundamentally transferred'[50] from the degree of asset specificity in an exchange relationship (or the degree to which assets are specifically designed or located for a particular use or user), since the higher degree would decrease the number of potential trading partners.[51] Essentially, the small-number issue relates closely to the research of monopoly/oligopoly in the Neoclassical Economics.[52] Moreover, one extremely important point highlighted by Williamson is that 'unless joined by the human factors, such environmental conditions need not impede market exchange'.[53] Therefore, market failures based on the Neoclassical Economics only see problems partially. Much more attention should be paid to other two human factors within the organisational failures framework, namely, 'opportunism' and 'bounded rationality'. The former is defined as 'self-interest seeking with guile',[54] as the 'human nature as we know'.[55] The latter is, in a sense, that 'human behaviour is intendedly rational, but only boundedly so'.[56] The rationality of human behaviour may be limited by motivational causes.[57] On the whole, this framework could not only be used to explain and examine the causes of transaction costs, but also offer potential for extending the traditional market failures' framework to encompass a broader

49 O. E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications*, above note 10, at 31–33.
50 O. E. Williamson, *The Economic Institutions of Capitalism*, above note 11, at 61–63.
51 Ibid, at 52–56.
52 O. E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications*, above note 10, at 28–29.
53 Ibid, at 9.
54 Oliver E. Williamson, 'Opportunism and its Critics' (1993) 14 *Managerial and Decision Economics* 97, at 97.
55 Frank H. Knight, *Risk, Uncertainty, and Profit* (Houghton Mifflin Co., 1921), at 271.
56 Herbert A. Simon, *Administrative Behavior* (4th edn, Free Press, 1997), at 88.
57 Reinhard Selten, 'Bounded Rationality' (1990) 146 *Journal of Institutional and Theoretical Economics* 649, at 651–653.

institutional analysis of public policies.[58] The 'black box' of organisations is now opened.[59]

2.3. Comparative Institutional Analysis of Governance Structures

On the basis of its deeper analysis of organisations, the TCE further matches different types of transactions with alternative governance structures,[60] with an aim to explore within what kinds of governance a transaction will be secured at least cost.[61] However, given transaction costs are often difficult to be quantified, transaction costs are always assessed in a 'comparative institutional way', a qualitative way.[62] In other words, instead of measuring a precise quantity, the transaction cost approach is a comparative institutional analysis to examine 'comparative [transaction] costs of planning, adapting, and monitoring tasks completion under alternative governance structures'.[63]

Governance structures are defined by Williamson as 'the institutional matrix within which transactions are negotiated and executed'.[64] Governance structures aim to: (i) 'regulate the multi-person relationship over time', (ii) 'determine adjustment to factors arising in the course of the relationship', and (iii) 'promote orderliness and cooperation

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[58] John M. Bryson, 'The Policy Process and Organizational Form' (1984) 12 *Policy Studies Journal* 445, at 459–460.

[59] Claude Ménard, 'Inside the Black Box: The Variety of Hierarchical Forms' in John Groenewegen (ed), *Transaction Cost Economics and Beyond* (Kluwer, 1996), at 149–170.

[60] Martin Currie, and Marcello Messori, 'New Institutional and New Keynesian Economics' in Richard Arena and Christian Longhi (eds), *Markets and Organization* (Springer, 1998), at 175.

[61] Stephan Voight and Hella Engerer, 'Institutions and Transition – Possible Policy Implications of the New Institutional Economics' in Klaus F. Zimmermann (ed), *Frontiers in Economics* (Springer, 2002), at 128–129.

[62] O. E. Williamson, *The Economic Institutions of Capitalism*, above note 11, at 22; Michael Dietrich, *Transaction Cost Economics and Beyond: Towards A New Economics of the Firm* (Routledge, 1994), at 20.

[63] Oliver E. Williamson, 'The Modern Corporation: Origins, Evolution, Attributes' (1981) 19 *Journal of Economic Literature* 1537, at 1544.

[64] Oliver E. Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations' (1979) 22 *Journal of Law and Economics* 233, at 239.

in the on-going relationships'.[65] Therefore, 'administered contracts', which involve intervention from public agencies to provide long-term administrative supports, could be regarded as one kind of governance to tackle the hazards inherently unable to be remedied by most private alternatives.[66] Government, like 'a super-firm', is 'able to influence the use of factors of production by administrative decisions',[67] which may reduce transaction costs from the price mechanism greatly.[68] Also, 'regulation, in some form, is immanent from those in which market modes can be made to work relatively well',[69] so regulation, in this case, emerges as a governance structure for tackling contracting problems in the market.[70] Based on this understanding, regulation, together with government or other public institutions, arise as transaction-cost-minimising responses to govern certain economic activities.[71]

However, as mentioned by the organisational failures' framework, the administrative machine is not costless, and even, on occasions, is extremely costly.[72] Therefore, Dixit incorporates the organisational failures framework to analyse transaction costs of political organisations.[73] Williamson also extends the institutional spectrum of the TCE to encompass the role of public bureaucracy, admitting the costs

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[65] Barry H. Spicer and Van Ballew, 'Management Accounting Systems and the Economics of Internal Organization' (1983) 8 *Accounting, Organizations and Society* 73, at 75.
[66] Victor P. Goldberg, 'Regulation and Administered Contracts' (1976) 7 *The Bell Journal of Economics* 426, at 427–430.
[67] R. H. Coase, 'The Problem of Social Cost', above note 8, at 17.
[68] Ibid, at 17.
[69] Oliver E. Williamson, 'Franchise Bidding for Natural Monopolies-in General and with Respect to CATV' (1976) 7 *The Bell Journal of Economics* 73, at 73.
[70] Brian Levy and Pablo T. Spiller, 'The Institutional Foundations of Regulatory Commitment: A Comparative Analysis of Telecommunications Regulation' (1994) 10 *Journal of Law, Economics & Organization* 201, at 202.
[71] Oliver E. Williamson, 'Public and Private Bureaucracies: A Transaction Cost Economics Perspective' (1999) 15 *Journal of Law, Economics, & Organization* 306, at 334–336.
[72] R. H. Coase, 'The Problem of Social Cost', above note 8, at 18.
[73] A. K. Dixit, above note 1, at 45–47, 51–56.

caused and saved by it.[74] Administrative regulation is just one of the 'candidate modes' of suitable governance,[75] so there is no guarantee that it would always be a better choice than others. There should be an enquiry into the effects of a whole range of governance structures, and the main question would be which governance will actually work in practice.[76]

2.4. Limits and Implications of Transaction Cost Approach

Thanks to the above efforts, the notions and methodology of the TCE now are increasingly being applied outside the business-related fields,[77] and have foundational contributions to the study of 'non-market strategy'.[78] Having said that, the TCE itself is not without critics, which are almost as large as the TCE literature,[79] and obviously beyond the scope of this thesis. Instead, it is better to point out some weaknesses of an efficiency-based analysis for deciding institutional arrangements in government, such as, difficulties of comparison and making a choice in political reality.

First, since public agencies often have multiple or vague objectives and the output of government is complex and controversial, some argue that it is difficult to decide what is the 'efficiency/best' when accommodating considerations of equity and

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[74] Oliver E. Williamson, 'Transaction Cost Economics: How it Works: Where it is Headed' (1998) 146 *De Economist* 23, at 45–47.

[75] O. E. Williamson, 'Public and Private Bureaucracies: A Transaction Cost Economics Perspective', above note 71, at 307.

[76] R. H. Coase, 'The Regulated Industries—Discussion', above note 41, at 194–195.

[77] Jeffrey T. Macher and Barak D. Richman, 'Transaction Cost Economics: An Assessment of Empirical Research in the Social Sciences' (2008) 10 *Business & Politics* 1, at 31–38.

[78] Jr Rui J. P. de Figueiredo, 'Institutions, Politics, and Non-Market Strategy' (2010) 52 *California Management Review* 123, at 124.

[79] For a brief and comprehensive overview of this: see Nicolai J. Foss and Peter G. Klein, 'Critiques of Transaction Cost Economic: An Overview' in Peter G. Klein and Michael E. Sykuta (eds), *The Elgar Companion to Transaction Cost Economics* (Edward Elgar, 2010), at 263–272; Geoffrey M. Hodgson, 'Limits of Transaction Cost Analysis' in Peter G. Klein and Michael E. Sykuta (eds), *The Elgar Companion to Transaction Cost Economics* (Edward Elgar, 2010), at 297–305.

accountability into the transaction cost approach.[80] In order to respond to this concern, Williamson clarifies a 'remediableness criterion' of the transaction cost approach: 'an extant mode of organisation for which no superior feasible alternative can be described and implemented with expected net gains is presumed to be efficient'.[81] Therefore, from the normative perspective of the TCE, there is an implication that the current system of investment conduct regulation in the EU is 'presumed to be better' unless benefits of the planned institutional reform can be proven.

Second, it is argued that the transaction cost approach will 'have to be modified in essential ways' to deal effectively with public considerations because of the fundamental differences between economic and political organisations.[82] However, since this is a standard challenge to the premises of economic theories, it is not to downplay the transaction cost approach, but to highlight this approach should be fitted into other areas cautiously.[83] In this sense, we should not preclude the application of this fruitful economic approach in allocating competences in the EU.[84] The outcome of an institutional comparison based on the TCE may not be the sole consideration in deciding whether investment conduct supervision should be centralised in the CMU, but it provides a useful indication. The next section, thus, is going to apply the organisational failures framework within the TCE to examining different types of

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[80] James Q Wilson, *Bureaucracy: What Government Agencies do and Why They Do It* (Basic Books, 1989), at 347–348, 359.

[81] O. E. Williamson, 'Public and Private Bureaucracies: A Transaction Cost Economics Perspective', above note 71, at 316.

[82] Terry M. Moe, 'The Politics of Structural Choice: Toward A Theory of Public Bureaucracy' in Oliver E. Williamson (ed), *Organization Theory: From Chester Barnard to the Present and Beyond* (Oxford University Press, 1990), at 119–127.

[83] Terry M. Moe, 'The Positive Theory of Public Bureaucracy' in Dennis C. Mueller (ed), *Perspectives on Public Choice* (Cambridge University Press, 1996), at 476–477.

[84] Andreas Føllesdal, 'Subsidiarity' (1998) 6 *Journal of Political Philosophy* 190, at 206–207.

investment conduct governance.

3. Application of Transaction Cost Approach to Investment Conduct Governance

3.1. Organisational Failures of Market Discipline in Governing Investment Conduct

3.1.1. Environmental Factors

The uncertainty/complexity issues between investment firms and their clients are significant. This is because investors lack experience and have lower abilities to monitor investment firms: they are unable to compare and make a choice about intangible financial instruments, not to mention the content of investment services.[85] Investment services, which are generally described as 'credence goods' in economics that buyers can never be certain of the quality of the 'goods' they have purchased based on *ex post* observations, with the consequence that experts who provide the 'goods' have strong incentives to cheat buyers.[86] In this sense, investment services, as 'credence goods', are incomparable to many people. Also, this pattern makes it much easier for the general public to assess the performance of the whole investment services industry, rather than to assess the quality of an individual investment firm.[87]

Given the incomparability of investment services, the human-asset specificity of

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[85] David T. Llewellyn, 'Regulation of Retail Investment Services' (1995) 15 *Economic Affairs* 12, at 13–14; Gordon Cameron and Monica Sah, 'Controlling the Quality of Financial Advice: the Use of Regulatory Form to Satisfy Fiduciary Obligations' (1997) *Journal of Business Law* 143, at 144–146.

[86] Emons Winand, 'Credence Goods and Fraudulent Experts' (1997) 28 *The RAND Journal of Economics* 107, at 107–118.

[87] Peter D. Spencer, *The Structure and Regulation of Financial Markets* (Oxford University Press, 2000), at 34.

investment firms can be 'fundamentally transferred' to the issue of small numbers,[88] causing an incentive between parties to enter a long-term relationship.[89] In addition, investment firms, intrinsically, have fewer competitors due to the entry/exit requirement.[90] In combination of the incomparability of investment services and the entry/exit requirement of investment firms, this could possibly lead to market powers of investment firms.[91] Investment firms may abuse their market powers to charge prices higher than the level under perfect competition.[92] Apparently, the above environmental factors (i.e. the uncertainty/complexity and small numbers issues of investment services) are unable to cause organisational failures without the interaction of human factors. The environmental factors' influence has been subsumed by the human factors, namely, opportunism and bounded rationality.[93] The traditional disclosure regime, in this case, might not be enough to tackle the problems in this relationship, since it merely focuses on environmental factors.[94] A considerably difficult question is how to assure investment firms are genuine and are providing advice to their clients, free of conflicts and influences,[95] so the human factors is the real issue.

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[88] O. E. Williamson, *The Economic Institutions of Capitalism*, above note 11, at 61–63.
[89] Jeffrey Church and Roger Ware, *Industrial Organization: A Strategic Approach* (McGraw-Hill, 2000), at 69.
[90] For example, three kinds of preconditions for entry into the market (licensing, ownership restrictions, and capital requirements) are generally required: see Jeffrey Carmichael and Michael Pomerleano, *The Development and Regulation of Non-Bank Financial Institutions* (World Bank, 2002), at 56–59.
[91] Stijn Claessens, *Competition in the Financial Sector: Overview of Competition Policies* (International Monetary Fund, 2009), at 19.
[92] Saul Estrin et al, *Microeconomics* (5th edn, FT Prentice Hall, 2008), at 303–312.
[93] Gary Slater and David A. Spencer, 'The Uncertain Foundations of Transaction Costs Economics' (2000) 34 *Journal of Economic Issues* 61, at 65–68.
[94] Mads Andenas and Iris H-Y Chiu, *The Foundations and Future of Financial Regulation: Governance for Responsibility* (Routledge, 2014), at 242–243. See further in Section 3.3.4 of CHAPTER II (pp. 40–43).
[95] Omri Ben-Shahar and Carl E. Schneider, 'The Failure of Mandated Disclosure' (2011) 159 *University of Pennsylvania Law Review* 647, at 746–749. See further in Sections 3.3.5 and 3.3.6 of CHAPTER II (pp. 43–52).

3.1.2. Human Factor: Opportunism

Caused by opportunism, investment firms may exploit their informational advantages and other sources of relative powers in investment services markets to affect the benefits, risks and costs of the relationship between themselves and their clients.[96] Generally, when an investment firm has more knowledge or power than its client, there is a potential for the agent 'shirking',[97] or even 'abusing', its position—principal-agent problems happen here[98] and cause transaction costs.[99] These problems generally could be classified into two types: (i) hidden knowledge/adverse selection, which relates to difficulties in ascertaining objectively the quality of investment services purchased; and (ii) hidden action/moral hazard, which refers to the possibility of investment firms, during the contractual relationship, altering certain characteristics of investment services, in its own favour and to the detriment of their clients.[100] Opportunism may induce investment firms to 'mislead, distort, disguise, obfuscate, or confuse' information.[101]

Furthermore, if misaligning incentives of compensation structures between investment firms and their clients, the opportunism issue becomes even worse.[102] For

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[96] Toni Williams, 'Open the Box: An Exploration of the Financial Services Authority's Model of Fairness in Consumer Financial Transactions' in Mel Kenny, James Devenney and Lorna Fox O'Mahony (eds), *Unconscionability in European Private Financial Transactions* (Cambridge University Press, 2010), at 230.

[97] 'Shirking' means that agents will be lazy and shirk their responsibilities when given half a chance: see Eric W. Orts, 'Shirking and Sharking: A Legal Theory of the Firm' (1998) 16 *Yale Law & Policy Review* 265, at 276–277. Therefore, 'shirking' is only referred that agents are not carrying out their duties properly, and it should be distinguished from the 'abusing' their superior position.

[98] Iris H-Y Chiu, 'Delegated Regulatory Administration in Mandatory Disclosure - Some Observations from EU Securities Regulations' (2006) 40 *International Lawyer* 737, at 749–750.

[99] Costs of the principal-agent problem are defined by Jensen and Meckling as the sum of (i) 'the monitoring expenditures of the principal', (ii) 'the bonding expenditures by the agent', and (iii) 'the residual loss': see Michael C. Jensen and William H. Meckling, 'Theory of the firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305, at 308.

[100] Jean-Jacques Laffont and David Martimort, *The Theory of Incentives: The Principal-Agent Model* (Princeton University Press, 2002), at 12, Chs. 2 and 4.

[101] Oliver E. Williamson, 'The Economic of Governance: Framework and Implications' (1984) 140 *Journal of institutional and Theoretical Economics* 195, at 198.

[102] Iris H.-Y. Chiu, *Regulatory Convergence in EU Securities Regulation* (Kluwer Law International, 2008), at 24–25.

example, three types of 'mis-selling' are recognised in the wake of the global financial crisis of 2008–09: namely, investment firms may (i) misrepresent information; (ii) design or promote complex financial products; or (iii) provide non-customised advice, in order to gain more commissions or other benefits.[103] Inappropriate 'kick-back' system, thus, may undermine the principal obligation of investment firms to their clients, which is unable to be corrected simply by market forces.[104] There is an appreciable need for regulators' intervention to prevent abuse of the superior position in this relationship,[105] in particular investors neither expect market participants to defraud them nor have the resources or inclination to monitor these participants.[106]

3.1.3. Human Factor: Bounded Rationality

Based on the behavioural economics, five behavioural factors influence retail investors' choices have been identified in the European capital markets:

> [(i)] cognitive limitations—consumers [retail investors] struggle with even very simple investment choices, especially if older or less educated; [(ii)] trust in advice—advice is ubiquitous […] and consumers [retail investors] are usually, sometimes naively, trusting of advice they receive; [(iii)] attitudes to risk and ambiguity—investment choices are strongly influenced by perceived risk in investment returns or product complexity; [(iv)] framing effects—

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[103] Günter Franke, Thomas Mosk and Eberhard Schnebel, *Fair Retail Banking: How to Prevent Mis-selling by Banks* (Sustainable Architecture for Finance in Europe ('SAFE') White Paper No 39, 2016), at 4–7.
[104] Howell E. Jackson and Laurie Burlingame, 'Kickbacks or Compensation: The Case of Yield Spread Premiums' (2007) 12 *Stanford Journal of Law, Business & Finance* 289, at 289 and 312.
[105] Johannes Köndgen, 'Rules of Conduct: Further Harmonisation?' in Guido Ferrarini (ed), *European Securities Markets: The Investment Services Directive and Beyond* (Kluwer Law International, 1998), at 117–118. See further in Section 3.3.5 of CHAPTER II (pp. 43–48).
[106] Lynn A. Stout, 'The Investor Confidence Game' (2002) 68 *Brooklyn Law Review* 407, at 430–436.

cognitively-limited consumers [retail investors] make worse decisions when financial instruments are framed in harder-to-understand ways; [and (v)] familiarity and other heuristics—in the absence of advice, consumers [retail investors] may fall back on other (inappropriate) heuristics when making a choice.'[107]

Therefore, the rational assumption of investors may not be held. Furthermore, even professional investment firms are also affected by many irrational effects: (i) 'endowment effects', which 'signify that due to loss aversion people value what they own more than what they do not own, in the sense that they demand more money to give up an object than they would be prepared to pay to acquire it';[108] (ii) 'procrastination', which 'refers to the delay of taking an action, in spite of being aware that prompt action would be better';[109] (iii) 'complex risk assessment', which indicates 'the inability of professional intermediaries to realise' everything, such as, systemic risks;[110] (iv) 'overconfidence', which proves investment firms 'tend to be confident in their own judgement and rating assessment, even if they did not entirely understand the design of financial products';[111] (v) 'herding', which is 'a natural tendency of individuals to simplify complex decision taking processes that leads them to just copy decisions of others'.[112] These biases, to some extent, can guide further reforms on regulatory policies

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[107] Nick Chater, Steffen Huck and Roman Inderst, *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective* (Report to European Commission Directorate-General Health and Consumers (SANCO), 2010), at 388, available at: <http://ec.europa.eu/consumers/archive/strategy/docs/final_report_en.pdf> (accessed June, 2017).

[108] Gerald Spindler, 'Behavioural Finance and Investor Protection Regulations' (2011) 34 *Journal of Consumer Policy* 315, at 323.

[109] Ibid, at 323.

[110] Ibid, at 324.

[111] Ibid, at 324.

[112] Ibid, at 324.

and intervention,[113] conferring a 'debiasing' job of regulatory intervention in governing investment conduct.[114]

3.1.4. Emergence of Administrative Regulation

As shown by the organisational failures, high performance ambiguity and goal incongruence between investment firms and their clients, are very likely to lead an 'impersonal hierarchy/public bureaucratic relation' for reducing transaction costs.[115] Therefore, administrative regulation emerges as a 'comparatively efficient' form to govern investment conduct.[116] First, information costs can be reduced by standard disclosure rules;[117] second, agency costs between investment firms and their clients can be comparatively reduced by centralising monitoring and sanctioning activities in the hands of public entities;[118] and third, contracting costs can also be reduced by uniform provisions of providing services.[119]

However, the control mechanisms of administrative regulation may not be the most efficient, because all kinds of governance, to a greater or lesser degree, are 'in a

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113 Ronald J. Gilson and Reinier Kraakman, 'The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias' (2003) 28 *Journal of Corporation Law* 715, at 737–741.

114 Emilios Avgouleas, 'Reforming Investor Protection Regulation: The Impact of Cognitive Biases' in A. I. Ogus, Michael Faure and Frank H. Stephen (eds), *Essays in the Law and Economics of Regulation: In Honour of Anthony Ogus* (Intersentia, 2008), at 160–163. For further examples in MiFID II's rules: see, e.g., Section 3.3.3 of CHAPTER II regarding the marketing requirement (pp. 59–60) and Section 3.3.4 of CHAPTER II regarding the information requirement (pp. 40–41).

115 William G. Ouchi, 'Markets, Bureaucracies, and Clans' (1980) 25 *Administrative Science Quarterly* 129, at 134–135; David E. Bowen and Gareth R. Jones, 'Transaction Cost Analysis of Service Organization-Customer Exchange' (1986) 11 *The Academy of Management Review* 428, at 434–437.

116 Oliver E. Williamson, 'Contested Exchange Versus the Governance of Contractual Relations' (1993) 7 *The Journal of Economic Perspectives* 103, at 107.

117 S. J. Grossman and O. D. Hart, 'Disclosure Laws and Takeover Bids' (1980) 35 *The Journal of Finance* 323, at 333.

118 Thomas Iseli, Alexander F. Wagner and Rolf H. Weber, 'Legal and Economic Aspects of Best Execution in the Context of the Markets in Financial Instruments Directive (MiFID)' (2007) 1 *Law and Financial Markets Review* 313, at 316; Barbara Gabor, *Regulatory Competition in the Internal Market Comparing Models for Corporate Law, Securities Law and Competition Law* (Edward Elgar, 2013), at 128.

119 Benjamin Klein, 'Transaction Cost Determinants of "Unfair" Contractual Arrangements' (1980) 70 *The American Economic Review* 356, at 356-362.

state of at least partial failure'.[120] For example, it is generally questioned whether the disclosure regime is effective in overcoming the issue of bounded rationality—sunlight can be blinding.[121] The role of administrative regulation in mitigating the issue of bounded rationality also raises a heated debate, since it should not incautiously support a constraint on individual choices.[122] On account of the bounded rationality of regulators, a deeper analysis of 'anti-antipaternalism' is necessary.[123] Some are in favour of 'asymmetrical paternalism', in a form of intervention that 'creates large benefits for those people who are boundedly rational […] while imposing little or no harm on those who are fully rational'.[124] It is also possible to imagine 'libertarian paternalism', 'an approach that preserves freedom of choice but authorises both private and public institutions to steer people in directions that will promote their welfare'.[125] One further possible approach is to consider the role of law as 'debiasing' people.[126] Although the discussion of this question is complicated, all of these approaches are sort a form of 'weak' (soft) paternalism,[127] implying a significant fear of errors of administrative

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[120] William G. Ouchi, 'A Framework for Understanding Organizational Failure' in John R. Kimberly and Robert H. Miles (eds), *The Organizational Life Cycle: Issues in the Creation, Transformation, and Decline of Organizations* (Jossey-Bass Publishers 1981), at 426–427.

[121] Troy A. Paredes, 'Blinded by the Light: Information Overload and Its Consequences for Securities Regulation' (2003) 81 *Washington University Law Quarterly* 417, at 431–443.

[122] For a comprehensive summary of this debate: see Jeffrey J. Rachlinski, 'The Uncertain Psychological Case for Paternalism' (2003) 97 *Northwestern University Law Review* 1165, Parts II and III.

[123] Christine Jolls, Cass R. Sunstein and Richard Thaler, 'A Behavioral Approach to Law and Economics' (1998) 50 *Stanford Law Review* 1471, at 1541–1545.

[124] Colin Camerer et al, 'Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism"' (2003) 151 *University of Pennsylvania Law Review* 1211, at 1219.

[125] Richard H. Thaler and Cass R. Sunstein, 'Libertarian Paternalism' (2003) 93 *American Economic Review* 175, at 179.

[126] Christine Jolls and Cass R. Sunstein, 'Debiasing through Law' (2006) 35 *The Journal of Legal Studies* 199, at 206–224.

[127] If the rule is used coercively to deprive the individual of choice, that is often described as 'hard' (strong) paternalism; paternalism is, in contrast, 'soft' (weak) if freedom of choice is preserved, but the rule is used to nudge individuals towards what is generally considered to be a preferable course of conduct. For further discussion: see Anthony Ogus, 'The Paradoxes of Legal Paternalism and How to Resolve Them' (2010) 30 *Legal Studies* 61, at 62–63; Anthony Ogus and Willem H. van Boom, 'Introducing, Defining and Balancing 'Autonomy versus Paternalism'' in Anthony Ogus and Willem H.

regulation.[128] In particular, 'control imperfections' could be easily found in administrative regulation.[129]

3.2. Organisational Failures of Administrative Regulation in Governing Investment Conduct

3.2.1. Environmental Factors

No less than the market discipline, administrative regulation also faces the issue of uncertainty and/or complexity in governing investment conduct. First of all, information, from the institutional viewpoint, is not only an important input into the regulatory process (the instrumental role), but also one kind of regulatory policy (the constitutive role).[130] However, significant information asymmetries between regulators and regulatees will increase regulatory 'decision costs' in the administrative process.[131] Even if standing aside these information asymmetries, 'knowledge problems', which are caused by the frontier of scientific and technical knowledge, are also embedded in the abilities of regulators.[132] Furthermore, the issue of uncertainty/complexity might be even more serious since there are more limits of regulatory resources (such as, staff,

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van Boom (eds), *Juxtaposing Autonomy and Paternalism in Private Law* (Hart Publishing, 2011), at 2–3.

128 See, e.g., Jill E. Fisch, 'Regulatory Responses to Investor Irrationality: The Case of the Research Analyst' (2006) 10 *Lewis & Clark Law Review* 57, at 76–82; Cass R. Sunstein, 'Boundedly Rational Borrowing' (2006) 73 *The University of Chicago Law Review* 249, at 254–255; Edward L. Glaeser, 'Paternalism and Psychology' (2006) 73 *The University of Chicago Law Review* 133, at 142–156.

129 Antonio Estache and David Martimort, *Politics, Transaction Costs, and the Design of Regulatory Institutions* (World Bank Policy Research Working Paper No 2073, 1999), at 3–4.

130 Giandomenico Majone, 'The New European Agencies: Regulation by Information' (1997) 4 *Journal of European Public Policy* 262, at 264–265.

131 Adam R. Fremeth and Guy L. F. Holburn, 'Information Asymmetries and Regulatory Decision Costs: An Analysis of U.S. Electric Utility Rate Changes 1980-2000' (2012) 28 *Journal of Law, Economics, and Organization* 127, at 130–132.

132 Maril J. Rizzo and Douglas Glen Whitman, 'The Knowledge Problem of New Paternalism' (2009) *BYU Law Review* 905, at 910.

budget, administrative powers) in practice.[133] For example, regulation encounters some 'geographic interface' problems in an international market.[134] In cases where investment services are provided by an investment firm that does not have a physical presence within the regulators' borders, the regulators may have to consider (i) the characteristics of the investor, (ii) the nature of the access, (iii) the type of the financial products traded and/or (iv) the regulation of the firm's home country, to decide how to regulate it.[135] Even in other cases, where cross-border investment firms have a physical presence, obstacles to the co-operation between regulators could still be found, so that regulators need to evaluate (i) the nature of these entities, (ii) how their operations are conducted across borders, and (iii) the degree to which information that the supervisor requires domestically is available for entities with operations abroad.[136] Overall, in a comprehensive globalised and digitised capital market, organisational structures of regulators, as well as their information and knowledge, become more important in tackling cross-border issues increasingly.[137] In this sense, the growth of administrative regulation at the EU level, to some extent, owes much to the 'mismatch between existing institutional capacities and the growing complexity of policy problems'.[138]

In addition, the issues of small numbers are also relevant in the capital market regulation since administrative regulation is always considered as 'monopolistic'

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133 Jean-Michel Glachant et al, 'Implementing Incentive Regulation and Regulatory Alignment with Resource Bounded Regulators' (2013) 14 *Competition and Regulation in Network Industries* 264, at 268–272.
134 Richard Dale, *Risk and Regulation in Global Securities Markets* (John Wiley & Sons, 1996), at 11.
135 The International Organization of Securities Commissions ('IOSCO'), Regulation of Remote Cross-Border Financial Intermediaries, February, 2004, at 5–9, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD162.pdf> (accessed June, 2017).
136 IOSCO, Principles Regarding Cross-Border Supervisory Cooperation, May, 2010, at 38, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD322.pdf> (accessed June, 2017).
137 Alexander Wellerdt, *Organisation of Banking Regulation* (Springer, 2015), at 39–45.
138 Giandomenico Majone, 'The Rise of the Regulatory State in Europe' (1994) 17 *West European Politics* 77, at 85. See further in Section 4.1 of CHAPTER VI (pp. 275–285).

governance within its own territory.[139] Here we must examine the geographic and product scopes of the monopoly enjoyed by the regulators, in order to prevent an excessive monopoly and find the optimum level and scope at which to regulate[140]—this examination, inevitably, links to the principle of subsidiarity and the regulatory competition.[141]

3.2.2. Human Factor: Opportunism

Many scholars, as discussed in this section, have been asking whether regulators are opportunistic, due to the interests of regulators and the lobbying efforts of interested parties. First, the Chicago theory of regulation[142] strongly argues that regulators are incompetent, corrupt, and 'captured' by interest groups.[143] Regulation, thus, is a product allocated on the basis of demand by industry groups' pressure, which would make things even worse than no regulation.[144] The Virginia School of Public Choice further explains regulation as an outcome of 'rent-seeking',[145] which means

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139 Roberta Romano, 'Empowering Investors: A Market Approach to Securities Regulation' (1998) 107 *The Yale Law Journal* 2359, at 2365–2372.

140 JP Trachtman, 'Regulatory Competition and Regulatory Jurisdiction' (2000) 3 *Journal of International Economic Law* 331, at 334.

141 Ibid, at 334. See further in Section 4.2 of CHAPTER VI (pp. 285–291).

142 It is also called 'The Captured Theory', 'The Economic Theory of Regulation', 'The Chicago theory of government' or 'The Theory of Economic Regulation': see Johan den Hertog, 'General Theories of Regulation' in Boudewijn Bouckaert and Gerrit de Geest (eds), *Encyclopedia of Law and Economics* (Edward Elgar, 2000), at 235–236.

143 Richard A. Posner, 'Theories of Economic Regulation' (1974) 5 *The Bell Journal of Economics and Management Science* 335, at 343.

144 George J. Stigler, 'The Theory of Economic Regulation' (1971) 2 *The Bell Journal of Economics and Management Science* 3, at 3–21. This theory is later modelled by Peltzman and Becker: see Sam Peltzman, 'Toward a More General Theory of Regulation' (1976) 19 *Journal of Law and Economics* 211, at 211–240; and Gary S. Becker, 'A Theory of Competition Among Pressure Groups for Political Influence' (1983) 98 *The Quarterly Journal of Economics* 371, at 371–400.

145 See, e.g., James M. Buchanan, Robert D. Tollison and Gordon Tullock (eds), *Toward A Theory of the Rent-Seeking Society* (Texas A & M University 1980); Charles K. Rowley, Robert D. Tollison and Gordon Tullock (eds), *The Political Economy of Rent-Seeking* (Kluwer Academic Publishers 1988); Gordon Tullock, *Rent Seeking* (Edward Elgar, 1993). The term 'rent-seeking 'was coined by Krueger: see Anne O. Krueger, 'The Political Economy of the Rent-Seeking Society' (1974) 64 *The American Economic Review* 291, at 291–303.

'spending scarce resources on political action by individuals and groups to obtain monopoly rights or other favours' granted by regulation.[146] Regulators may decide a policy that is beneficial to specific groups or themselves in a costly way.[147] Although it is criticised on the overestimation of assumed losses of welfare in regulation,[148] the Public Choice theory indeed provides a different perspective to evaluate waste and inefficiency of administrative regulation in the allocation of scarce resources.[149] The Public Choice theory considers financial regulators, such as, the Securities and Exchange Commission in the USA ('US SEC'), have no difference to highly politicised organisations[150] that are 'intent on preserving their own bureaucratic turf despite the mounting evidence of their own obsolescence and irrelevance'.[151] Thus, like 'the counterpart of "market failure" is "regulatory failure"[,] the counterpart of "market abuse" is "regulatory opportunism".'[152]

In brief, institutionalists view the efficiency of administrative regulation as jointly influenced by 'governmental opportunism' and 'third party opportunism': the former 'consists of the ability of [regulators] to change the rules of the game via the standard

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146 J. d. Hertog, above note 142, at 243–244.

147 Oliver James, 'Regulation inside Government: Public Interest Justifications and Regulatory Failures' (2000) 78 *Public Administration* 327, at 333–338.

148 Hal R. Varian, 'Measuring the Deadweight Costs of Dup and Rent Seeking Activies' (1989) 1 *Economics & Politics* 81, at 92.

149 Nicholas Mercuro and Steven G. Medema, *Economics and the Law: From Posner to Post-Modernism and Beyond* (2nd edn, Princeton University Press, 2006), at 201–204, 230–231.

150 Donald C. Langevoort, 'The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation' (1990) 47 *Washington and Lee Law Review* 527, at 527–540.

151 Jonathan R. Macey, 'Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty' (1994) 15 *Cardozo Law Review* 909, at 948. However, some claim this is an unrealistic overstatement in response to Professor Macey's argument: see David L. Ratner, 'The SEC at Sixty: A Reply to Professor Macey' (1995) 16 *Cardozo Law Review* 1765, at 1769–1779.

152 Frank Bickenbach, Lars Kumkar and Rüdiger Soltwedel, 'Antitrust and Regulation—The View of New Institutional Economics' in Klaus F. Zimmermann (ed), *Frontiers in Economics* (Springer, 2002), at 193.

use of [regulatory] powers to extract the quasi-rents';[153] and the latter could be seen as challenges given by interested third parties, interest groups, public, or even other regulators to the regulators.[154] As described by Professor Langevoort, capital market regulators 'operate in a complex political ecology, making law in response to a multitude of shifting incentives, both external and internal.'[155] Causes of these two types of opportunism are closely associated with the arrangement of governance, so the solution to them should also be based on the nature of regulatory institutions, the operation of regulation and the performance of the whole mechanism.[156] This calls for a deeper analysis of the inefficiency of regulatory contracts and of the regulatory outcomes within a proper institutional comparison.[157]

3.2.3. Human Factor: Bounded Rationality

Organisations may evolve and adapt to minimise the impact of bounded rationality on individuals to some extent.[158] Nevertheless, given a belief that psychological errors are understood to be endogenous, there are good reasons to consider whether society is better off if error correction is supplied by individuals in markets, or by individuals in government.[159] In particular, exports and regulators are subject to cognitive and motivational problems that could inhibit good decision-making.[160] The global financial

[153] Pablo T. Spiller, 'Transaction Cost Regulation' (2013) 89 *Journal of Economic Behavior & Organization* 232, at 234.
[154] Ibid, at 237–239.
[155] Donald C. Langevoort, 'The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty' (2006) 84 *Washington University Law Review* 1591, at 1623.
[156] P. T. Spiller, above note 153, at 233.
[157] Pablo T. Spiller, 'Regulation: A Transaction Cost Perspective' (2010) 52 *California Management Review* 147, at 154–155. See further in Section 4.3 of CHAPTER VI (pp. 291–296).
[158] Chip Heath, Richard P. Larrick and Joshua Klayman, 'Cognitive Repairs: How Organizational Practices Can Compensate for Individual Shortcomings' (1998) 20 *Review in Organizational Behavior* 1, at 5–22.
[159] E. L. Glaeser, above note 128, at 142–149.
[160] C. Jolls, C. R. Sunstein and R. Thaler, above note 123, at 1543–1544; Richard A. Posner, 'Rational

crisis of 2008–09, for example, is a confirmation that regulators face rationality constraints too.[161] For now, the existence of many regulatory biases have been confirmed: (i) 'flawed heuristics and myopia', which lead regulators estimate probabilities irrationally and then overreaction; (ii) 'status quo biases', which cause regulatory inertia and path dependency; and (iii) 'confirmation biases', which result in resistance to change a regulatory course, even in face of contrary evidence.[162] The forgoing regulatory biases are even considered as 'pathologies' of the US SEC,[163] providing a strong argument questioning the corrective role of regulators.[164]

Given the regulators' behaviour is not rational as the Public Choice theory[165] assumed, the above behavioural research, to some extent, complement and enrich the rational actor assumptions of the Public Choice theory. In return, the corrective mechanisms of bounded rationality might also be found in the Public Choice theory: namely, appropriate institutional arrangements of governance. By two means of reforming institutional arrangements of governance, bounded rationality may be cured: one is 'insulation' by eliminating (or making more difficult to choose) poor alternatives;

Choice, Behavioral Economics, and the Law' (1998) 50 *Stanford Law Review* 1551, at 1575; Joshua D. Wright and Douglas H. Ginsburg, 'Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty' (2012) 106 *Northwestern University Law Review* 1033, at 1063–1065.

161 Carmine Di Noia and Matteo Gargantini, 'Unleashing the European Securities and Markets Authority: Governance and Accountability After the ECJ Decision on the Short Selling Regulation (Case C-270/12)' (2014) 15 *European Business Organization Law Review* 1, at 46.

162 James C. Cooper and William E. Kovacic, 'Behavioral Economics: Implications for Regulatory Behavior' (2012) 41 *Journal of Regulatory Economics* 41, at 44–49; James C. Cooper and William E. Kovacic, 'Behavioral Economics and Its Meaning for Antitrust Agency Decision Making' (2012) 8 *Journal of Law, Economics & Policy* 779, at 785–791; see also Oskari Juurikkala, 'Behavioral Paradox: Why Investor Irrationality Calls for Lighter and Simpler Financial Regulation' (2012) 18 *Fordham Journal of Corporate & Financial Law* 33, at 79–81.

163 A. C. Pritchard, 'The SEC at 70: Time for Retirement?' (2005) 80 *Notre Dame Law Review* 1073, at 1078–1089.

164 Stephen J. Choi and A. C. Pritchard, 'Behavioral Economics and the SEC' (2003) 56 *Stanford Law Review* 1, at 20–36; Stephen J. Choi, 'Behavioral Economics and the Regulation of Public Offerings Business Law Forum Behavioral Analysis of Corporate Law' (2006) 10 *Lewis & Clark Law Review* 85, at 122–126.

165 See Section 3.2.2 above (pp. 155–157).

and another is 'de-biasing' by other review functions or institutions.[166] The latter solution significantly highlights the complementary role of other governance outside administrative regulation, such as, judicial review and political oversight,[167] regulatory competition of the regulators' market,[168] or even 'monitored experimentalism' of regulators.[169] In this sense, investment conduct is not merely governed by administrative regulation, but also controlled by other types of governance (e.g., private law). We should pay equal attention to these types of governance that we always ignored.

3.2.4. Imperfect but Necessary Administrative Regulation

The story told by opportunism and bounded rationality indicates the 'regulatory failures' of administrative regulation in governing investment conduct.[170] Blindly relying on administrative regulation is a mistake, because this diminishes the market's ability to overcome some issues. However, it should still be recognised there is a need for public intervention, since there is strong empirical evidence supporting the view that regulation is advantageous to the development of financial markets.[171] In fact, the need for administrative regulation has arisen very recently due to two significant changes of markets. First, technological advances have created new methods of trading,

166 J. C. Cooper and W. E. Kovacic, 'Behavioral Economics: Implications for Regulatory Behavior', above note 162, at 52–56; J. C. Cooper and W. E. Kovacic, 'Behavioral Economics and Its Meaning for Antitrust Agency Decision Making', above note 162, at 795–799.
167 S. J. Choi and A. C. Pritchard, above note 164, at 36–40.
168 O. Juurikkala, above note 162, at 86.
169 C. Di Noia and M. Gargantini, above note 161, at 46. See further in Section 4.4 of CHAPTER VI (pp. 296–300).
170 O. James, above note 147, at 333–339.
171 Edward Glaeser, Johnson Simon and Andrei Shleifer, 'Coase versus the Coasians' (2001) 116 *The Quarterly Journal of Economics* 853, at 853–897.

accompanied with a need to replace the traditional governance.[172] It becomes difficult to control these 'anonymous, digitalised and globalised' contemporary marketplaces by private law alone.[173] Second, in the higher linked markets, a private and individual risk of some rather wealthy groups may become a risk of the whole society, rendering an innovation of administrative regulation.[174] In particular, 'financial markets have become the most important institution of modern societies',[175] whose operation affects the livelihoods of large parts of the population. 'Case-to-case' private law, thus, may not be able to take problems of the whole society.

Specifically, since (i) private-law standards might be too broad and too vague to let a client of the investment firm feels (un)confident that misconduct will be found by the court; and (ii) an individual client's claim will often be too small to make it worthwhile to sue the investment firm,[176] there is a high risk of the 'rational apathy' phenomenon on investment firms' clients in traditional private law systems.[177] Administrative regulation, thus, may be seen as a response to 'a regulatory failure of [traditional] private law […] in response to new policy objectives',[178] with the aim to complete the 'incomplete' private law systems.[179] As some commentators claim, given the existence

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172 Marc Kruithof, 'A Differentiated Approach to Client Protection: The Example of MiFID' in Stefan Grundmann and Yesim M. Atamer (eds), *Financial Services, Financial Crisis and General European Contract Law: Failure and Challenges of Contracting* (Kluwer Law International, 2011), at 106.
173 Emilios Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis* (Oxford University Press, 2005), at 159.
174 M. Kruithof, above note 172, at 106–107.
175 E. Avgouleas, above note 173, at 159.
176 Luca Enriques, 'Conflicts of Interest in Investment Services: The Price and Uncertain Impact of MiFID's Regulatory Framework' in Guido Ferrarini and Eddy Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, The MiFID and Beyond* (Oxford University Press, 2006), at 324.
177 Rüdiger Veil and Fabian Walla, 'Sanctions' in Rüdiger Veil (ed), *European Capital Markets Law* (Hart Publishing, 2013), at 125.
178 Hugh Collins, *Regulating Contracts* (Oxford University Press, 1999), at 77–78.
179 Katharina Pistor and Chenggang Xu, 'Incomplete Law' (2003) 35 *New York University Journal of International Law and Politic* 931, Parts IV and V.

of the MiFID regime in the EU[180]:

> '[i]nvestment services is probably the most important example for the phenomenon that contract law in the area of financial services is partly superseded by (market) supervision rules.'[181]

It should be noted that private law is just 'partly superseded' by administrative regulation, so an equal appreciation should still be given to the 'responsive function'[182] of private law systems that complemented the weaknesses of administrative regulation in the financial crisis.[183]

3.3. Private Law Systems as Alternatives in Governing Investment Conduct

3.3.1. Old Position of Private Law Systems

The traditional approach sees private law systems and administrative regulatory systems as 'born enemies', and this tension may trace back to the divide between private law and public law in the Roman model of civil law.[184] The Roman model of civil law conceives of law as being a series of relationships existing between person and person, the person and the thing, and the person to the State: the first relationship gave rise to an action *in personam* (against a person), and the second to an action *in rem* (against a

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180 See further in Section 3.3 of CHAPTER II (pp. 32–61).

181 Stefan Grundmann and Jörg Hollering, 'EC Financial Services and Contract Law–Developments 2005–2007' (2008) 4 *European Review of Contract Law* 45, at 59.

182 This will be discussed in Section 3.3.2 below (pp. 163–165).

183 Michael Bridge and Jo Braithwaite, 'Private Law and Financial Crises' (2013) 13 *Journal of Corporate Law Studies* 361, at 361–367.

184 Johannes Köndgen, 'Policy Responses to Credit Crises: Does the Law of Contract Provide an Answer?' in Stefan Grundmann and Yesim M. Atamer (eds), *Financial Services, Financial Crisis and General European Contract Law: Failure and Challenges of Contracting* (Kluwer Law International, 2011), at 38.

thing);[185] these two were then amalgamated under the general heading 'Private Law' and distinguished from the third relationship 'Public Law'.[186] 'Public law' might be defined as laws relating to 'the constitution, and the maintenance and regulation of governmental authority',[187] which is steeped in politics and collective interests.[188] 'Private law', it may further be argued focuses on the individual's right to 'corrective justice', which 'treats the wrong, and the transfer of resources that undoes it'.[189] It is worthy to note that, in contrast to the civil law system, emergence of the private/public divide is comparatively late in the common law system.[190] Until the nineteenth century, the idea of 'markets' brought the divide of private/public law into the common law system,[191] followed by some critics on the utility[192] and the clarity[193] of this dichotomy.

Indeed, the line between public and private law is not uniform and clear,[194] in particular with the significant differences between the common law and civil law systems.[195] Some even argue that 'the' public/private distinction is 'one of the longest

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185 Herbert Felix Jolowicz, *Roman Foundations of Modern Law* (Clarendon Press, 1957), Ch. VIII.
186 Ibid, Ch. VI.
187 Martin Loughlin, *The Idea of Public Law* (Oxford University Press, 2004), at 1.
188 Ibid, Ch. 9.
189 Ernest J Weinrib, *The Idea of Private Law* (2nd edn, Oxford University Press, 2012), at 56.
190 For reasons of this late: see John Henry Merryman, 'The Public Law-Private Law Distinction in European and American Law' (1968) 17 *Journal of Public Law* 3, at 3–19.
191 Morton J. Horwitz, 'History of the Public/Private Distinction' (1982) 130 *University of Pennsylvania Law Review* 1423, at 1423–1427.
192 Carol Harlow, '"Public" and "Private" Law: Definition without Distinction' (1980) 43 *The Modern Law Review* 241, at 241–265; J.W.F. Allison, *A Continental Distinction in the Common Law: A Historical and Comparative Perspective on English Public Law* (Oxford University Press, 1996), Ch. 11.
193 Duncan Kennedy, 'The Stages of the Decline of the Public/Private Distinction' (1982) 30 *University of Pennsylvania Law Review* 1349, at 1349–1356; Dawn Oliver, 'What, If Any, Public-Private Divides Exist in English Law?' in Matthias Ruffert (ed), *The Public-Private Law Divide: Potential for Transformation?* (British Institute of International and Comparative Law, 2009), at 16.
194 For different distinctions: see Randy E. Barnett, 'The Foreword: Four Senses of the Public Law-Private Law Distinction Limits of Public Law--A Symposium Sponsord by the Institute for Humane Studies' (1986) 9 *Harvard Journal of Law & Public Policy* 267, at 267–276. Recently, Professor Barker lists at least twelve different distinctions of private/public law: see Kit Barker, 'Private Law' in Kit Barker and Darryn Jensen (eds), *Private Law: Key Encounters with Public Law* (Cambridge University Press, 2013), at 20–21.
195 Michaels and Jansen claim these differences are caused by the different ideas of 'private law' and 'state'

lies', due to the fact that many distinctions between public and private laws are almost never doctrinally dispositive.[196] The divide of private/public law, thus, might better be re-classified as 'facilitative'/'interventionist' law based on the extent of the impacts on parties: the former are used for mutually desired outcomes, generating winners and few or no losers; while the latter is designed to protect defined interests and/or supersede voluntary transactions, impacting significantly on losers as well as winners.[197] In the light of this new proposed divide, private law systems have a new life—namely, a regulatory context of private law systems.

3.3.2. New Life of Private Law Systems

Essentially, private law and public law are based on similar concepts of 'responsibility',[198] so there are 'common underlying values in public and private law'.[199] From the economics viewpoint, both of them are necessary for the well functioning of a free market.[200] Therefore, post-classical private law is characterised by 'its linkages with regulatory and distributive policies and its opening to social values and human rights'.[201] Private law incorporates public policies and has its regulatory role.[202] Although some

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in these two legal systems: for a comprehensive analysis with regard to these differences: see Ralf Michaels and Nils Jansen, 'Private Law beyond the State? Europeanization, Globalization, Privatization' (2006) 54 *The American Journal of Comparative Law* 843, at 846–860.

[196] William Lucy and Alexander Williams, 'Public and Private: Neither Deep nor Meaningful?' in Kit Barker and Darryn Jensen (eds), *Private Law: Key Encounters with Public Law* (Cambridge University Press, 2013), at 45.

[197] Anthony Ogus, 'The Regulation of Services and the Public–Private Divide' in Fabrizio Cafaggi and Horatia Muir Watt (eds), *The Regulatory Function of European Private Law* (Edward Elgar, 2009), at 12.

[198] See further in Peter Cane, *Responsibility in Law and Morality* (Hart Publishing, 2002), Ch. 8.

[199] Dawn Oliver, 'Common Values in Public and Private Law and the Public/Private Divide' [1997] *Public Law* 630, at 630–631; Oliver further analyses five common values, which are autonomy, dignity, respect, status and security: see Dawn Oliver, 'The Underlying Values of Public and Private Law' in Michael Taggart (ed), *The Province of Administrative Law* (Hart Publishing, 1997), at 217–242.

[200] Cass R. Sunstein, *Free Markets and Social Justice* (Oxford University Press, 1997), at 5.

[201] Christian Joerges, 'The Challenges of Europeanization in the Realm of Private Law: A Plea for a New Legal Discipline' (2004) 14 *Duke Journal of Comparative and International Law* 149, at 150.

[202] Hugh Collins, 'Regulating Contract Law' in Christine Parker et al (eds), *Regulating Law* (Oxford University Press, 2004), at 15–17; Hugh Collins, 'Governance Implications for the European Union of

may fear this is some sort of instrumentalisation to downgrade the role of private law,[203] the fact is this is an upgrade of private law by admitting its broader role in the regulatory context.

Many practical cases in the contemporary legal system can prove this. First, consumer law is conceptualised as governance of consumer markets and as a 'toolbox' of public, private and self-regulatory techniques by most scholars.[204] It, thus, may be regarded as part of private law and part of public law.[205] Second, company law provides another good example: on the one hand, it is an enabling law helps the efficient use of party autonomy and, on the other hand, it is a regulatory regime aiming to protect the interests of third parties or the weaker parties.[206] In this sense, company law may be either private or public. Third, there is a newly regulatory context of financial contract law, which is the so-called 'contract governance'[207] or 'regulatory contract law'.[208] Contract law's function has extended from 'governance of contracts' (an element of the institutional framework for private transactions) to 'governance by means of contract

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the Changing Character of Private Law' in Fabrizio Cafaggi and Horatia Muir Watt (eds), *Making European Private Law: Governance Design* (Edward Elgar Publishing, 2010), at 276–278.

203 Peter Cane, 'Tort Law as Regulation' (2002) 31 *Common Law World Review* 305, at 330–331; Jane Stapleton, 'Regulating Torts' in Christine Parker et al (eds), *Regulating Law* (Oxford University Press, 2004), at 125–126.

204 See, e.g., Colin Scott, Julia Black and Ross Cranston, *Cranston's Consumers and the Law* (3rd. edn, Butterworths, 2000), Parts I, II and III; Iain Ramsay, 'Consumer Law, Regulatory Capitalism and the New Learning in Regulation' (2006) 28 *Sydney Law Review* 9, at 9–35; Iain Ramsay, *Consumer Law and Policy: Text and Materials on Regulating Consumer Markets* (3rd edn, Hart Publishing, 2012), Ch. 3.

205 Ewoud Hondius, 'Consumer Law and Private Law: Where the Twains Shall Meet' in Ludwig Krämer, Hans-W. Micklitz and Klaus Tonner Nomos (eds), *Law and Diffuse Interests in the European Legal Order* (Nomos, 1997), at 312–313.

206 Stefan Grundmann, 'On the Unity of Private Law from a Formal to a Substance-Based Concept of Private Law' (2010) 18 *European Review of Private Law* 1055, at 1063–1066.

207 Florian Möslein, 'Contract Governance within Corporate Governance: A Lesson from the Global Financial Crisis' (2011) 6 *The IUP Journal of Governance and Public Policy* 7, at 7–25; Karl Riesenhuber, 'A Need for Contract Governance?' in Stefan Grundmann and Yesim M. Atamer (eds), *Financial Services, Financial Crisis and General European Contract Law: Failure and Challenges of Contracting* (Kluwer Law International, 2011), at 62.

208 J. Köndgen, 'Policy Responses to Credit Crises: Does the Law of Contract Provide an Answer?', above note 184, at 40.

law' (an instrument for steering behaviour and in order to achieve regulatory goals).[209] Inspired by this change, many new areas of European financial law (such as, MiFID[210] and Consumer Credit Directive[211]) have been developed within contract law which are regulatory in substance.[212]

3.3.3. Long-Standing Distinction between Private Law and Public Law

Even though the 'dichotomy/divide' of private/public law is theoretically unconvincing and disappearing, this does not render the 'distinction' meaningless.[213] Rather, various public/private distinctions provide different, but equally valuable, indications in deciding what to do in different, or even opposite, cases.[214] This 'multi-functional and context-dependent' approach could be valuable to justify and rationalise certain choices (such as, the applicability of certain legal procedures and the adoption of certain substantive principles) in various legal systems.[215] It should be emphasised that, although various distinctions exist, 'there is an unavoidable and fundamental division of authorities over law-making and prosecution among various institutional types, characterised most basically by their public or private nature'.[216]

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209 Florian Möslein and Karl Riesenhuber, 'Contract Governance – A Draft Research Agenda' (2009) 5 *European Review of Contract Law* 248, at 268–281.

210 See further in Section 3.3 of CHAPTER II (pp. 32–61).

211 Directive 2008/48/EC on credit agreements for consumers, 2008 OJ L133/66.

212 Stefan Grundmann, 'European Law and Principles on Commercial and Investment Banking Contracts: An Advanced Area of Codification' in Arthur S. Hartkamp et al (eds), *Towards a European Civil Code* (4th edn, Kluwer Law International, 2011), at 815.

213 Due to the 'hybridisation' of private/public law, it would be preferable to use the term 'interaction' or 'distinction' in this context, instead of 'divide' or 'dichotomy': Lorenzo Casini, *'Down the Rabbit Hole': The Projection of the Public/Private Distinction Beyond the State* (NYU Jean Monnet Working Paper No 8/2013, 2013), at 9.

214 William Lucy, 'Private and Public: Some Banalities About a Platitude' in Cormac Mac Amhlaigh, Claudio Michelon and Neil Walker (eds), *After Public Law* (Oxford University Press, 2013), at 80–82.

215 Gerdy Jurgens and Frank van Ommeren, 'The Public-Private Divide in English and Dutch Law: A Multifunctional and Context-Dependant Divide' (2012) 71 *The Cambridge Law Journal* 172, at 175–199.

216 Christian Turner, 'Origins of the Public/Private Theory of Legal Systems' in Kit Barker and Darryn Jensen (eds), *Private Law: Key Encounters with Public Law* (Cambridge University Press, 2013), at 118. Professor Turner advanced his theory in 2012, along with a concise table to explain it. See Christian

Courts and administrative authorities are very unlike.[217] The idea of 'path dependence' in the NIE could further explain why this private/public distinction based on different natures of authorities has astonishing longevity.[218]

Given this long-standing distinction, private law systems and administrative regulation have their own strengths. Compared to administrative regulation, private law systems have a number of advantages: (i) private law systems are more reliable and predictable than administrative regulation, because private law decisions are subject to the doctrine of precedent or other formal jurisprudence;[219] (ii) private law systems have comparatively less costs of monitoring, in some situations, because administrative authorities lack resources for specific cases, and, thus, have to pay more detection costs;[220] (iii) individuals have an incentive and personal motivation to be active on their own cases in private law systems;[221] and (iv) private law systems are lack of chances to be 'captured' (influenced) either by the industry or by the political system.[222] In contrast, administrative regulation still owns some inherent advantages over private law systems: (i) unlike judges, regulators can be experts and motivated to pursue social objectives in

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Turner, 'Law's Public/Private Structure ' (2012) 39 *Florida State University Law Review* 1003, at 1012.

217 See further in Section 4.2 below (pp. 172–174).

218 Based on the idea of path dependence, this is an outcome of 'self-reinforcing' (such as, large fixed costs, learning effects, and adaptive expectations in different private/public authorities). Daniela Caruso, 'The Missing View of the Cathedral: The Private Law Paradigm of European Legal Integration' (1997) 3 *European Law Journal* 3, at 7–8. For further discussion regarding the idea of path dependence: see Section 5.3 below (pp. 184–186).

219 Alastair Hudson, 'The Synthesis of Public and Private in Finance Law' in Kit Barker and Darryn Jensen (eds), *Private Law: Key Encounters with Public Law* (Cambridge University Press, 2013), at 237–238.

220 C. Scott, J. Black and R. Cranston, above note 204, at 513.

221 Steven Shavell, 'The Fundamental Divergence between the Private and the Social Motive to Use the Legal System' (1997) 26 *Journal of Legal Studies* 575, at 577–578.

222 Andrea Perrone and Stefano Valente, 'Against All Odds: Investor Protection in Italy and the Role of Courts' (2012) 13 *European Business Organization Law Review* 31, at 43. For more discussion regarding 'capture': see Section 3.2.2 above (pp. 155–156).

specific technical areas;[223] (ii) administrative regulation can act pre-emptively and proactively;[224] and (iii) administrative regulation is less likely to be subverted by large firms.[225]

3.3.4. Flawed but Indispensable Private Law Systems

In fact, neither a belief in the benevolence of courts nor in the omniscience of judges is right.[226] The issues of opportunism and bounded rationality are not confined to administrative regulation. Some empirical evidence supports the view that courts around the world could also be highly inefficient, politically motivated, slow, unfamiliar with the economic issues, and even corrupt.[227] Nevertheless, empirical evidence also indicates that, in contrast to the modest role of administrative regulation (except disclosure requirements), there is a strong correlation between the well functioning of private law systems and the development of capital markets.[228] Private law systems are equally important to capital markets.

From the institutional viewpoint, '[p]rivate law is not only a system of norms but also a set of institutional arrangements for creating and sustaining norms, and a set of social practices around those norms and institutions'.[229] Therefore, private law systems,

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223 E. Glaeser, J. Simon and A. Shleifer, above note 171, at 855 and 897.

224 K. Pistor and C. Xu, above note 179, at 1010–1011.

225 Professors Glaeser and Shleifer design a model to claim that 'the efficiency of regulation comes precisely from the fact that the penalties associated with a pure liability regime are too high, and therefore in such a regime justice is subverted'. Edward L. Glaeser and Andrei Shleifer, 'The Rise of the Regulatory State' (2003) 41 *Journal of Economic Literature* 401, at 408–413.

226 Andrei Shleifer, 'Efficient Regulation' in Daniel P. Kessler (ed), *Regulation versus Litigation: Perspectives from Economics and Law* (University of Chicago Press, 2011), at 31–37.

227 Simon Johnson, John McMillan and Christopher Woodruff, 'Property Rights and Finance' (2002) 92 *American Economic Review* 1335, at 1335–1356; Simeon Djankov et al, 'Courts' (2003) 118 *Quarterly Journal of Economics* 453, at 453–517.

228 Rafael La Porta, Florencio Lopez-De-Silanes and Andrei Shleifer, 'What Works in Securities Laws?' (2006) 61 *Journal of Finance* 1, at 1–32; James R. Barth, Gerard Caprio Jr and Ross Levine, 'Bank Regulation and Supervision: What Works Best?' (2004) 13 *Journal of Financial Intermediation* 205, at 205–248.

229 Peter Cane, 'The Anatomy of Private Law Theory: A 25th Anniversary Essay' (2005) 25 *Oxford Journal*

as one type of governance, have two indispensable tasks in capital markets. First, private law and private litigation now become almost a last resort to those seeking protection in the cases of regulatory failures.[230] Since private law touches financial matters in nature (such as, contracts, promissory notes, bills of exchange, derivatives and bonds),[231] private law systems possess some considerable efficiency and reflexivity (for example, contractual parties could negotiate the terms of contract) over administrative regulation.[232] Second, private law also has a 'deterrent effect' and a 'protective effect' through the threat of civil damages, which has the regulatory context on the behaviour of parties for the benefit of all of the parties, third parties, and society at large.[233]

In sum, given the equal importance of private law systems and administrative regulation in capital markets, as Professor Richard Posner said:

> '[t]he choice is rarely between a free market and public regulation. Ordinarily the choice is between two methods of public control, the common law system of privately enforced rights and the administrative system of direct public control. The choice between them should depend upon a weighting of their strengths and

of Legal Studies 203, at 217.

230 J. Köndgen, 'Policy Responses to Credit Crises: Does the Law of Contract Provide an Answer?', above note 184, at 39; Olha O. Cherednychenko, 'The Regulation of Retail Investment Services in the EU: Towards the Improvement of Investor Rights?' (2010) 33 *Journal of Consumer Policy* 403, at 422; Thomas Wilhelmsson, 'The Paradox of the Risk Society and the Fragmentation of Consumer Law' in I. Ramsay et al (eds), *Risk and Choice in Consumer Society* (Athènes, 2007), at 11.

231 Lars Gorton, 'Financial Law in a Global Surrounding' (2012) 23 *European Business Law Review* 913, at 915–916.

232 H. Collins, *Regulating Contracts*, above note 178, at 56–62 and 66–69. See also Tony Prosser, 'Regulatory Agencies, Regulatory Legitimacy, and European Private Law' in Fabrizio Cafaggi and Horatia Muir Watt (eds), *Making European Private Law: Governance Design* (Edward Elgar, 2008), at 241.

233 H. Collins, *Regulating Contracts*, above note 178, at 69–87; Robert Wai, 'Transnational Liftoff and Juridicial Touchdown: The Regulatory Function of Private International Law in an Era of Globalization' (2002) 40 *Columbia Journal of Transnational Law* 209, at 232–236.

weaknesses in particular contexts.'[234]

In other words, from the perspective of the TCE, an institutional comparison of investment conduct governance not only has to compare different arrangements of administrative regulation, but also has to find out whether court enforcement or administration by regulatory agencies is a more effective mean of governing those relations.[235]

4. Institutional Selection of Investment Conduct Governance

4.1. Basic Framework of Institutional Selection

According to the New Comparative Economics, which is a new formalisation of the NIE by studying what constitutes appropriate governance for different societies, there are four distinct strategies of institutional design depending on 'the degree of public control': market discipline, private law, administrative regulation, and state ownership.[236] These four general types of governance are possible institutional solutions arrayed along the convex of 'institutional possibilities frontier' ('IPF').[237] In terms of the optimum institutional governance, it will be presumed at the point that minimises social losses on the IPF.[238] Since IPFs are determined by social, cultural, and other factors, different societies, even a same country in different times, have different IPFs and

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234 Richard A. Posner, *Economic Analysis of Law* (8th edn, Kluwer Law International, 2011), at 487.
235 Keith J. Crocker and Scott E. Masten, 'Regulation and Administered Contracts Revisited: Lessons from Transaction-Cost Economics for Public Utility Regulation' (1996) 9 *Journal of Regulatory Economic* 5, at 10–13.
236 Simeon Djankov et al, 'The New Comparative Economics' (2003) 31 *Journal of Comparative Economics* 595, at 601–604.
237 Ibid, at 599.
238 Ibid, at 600.

optimum points.[239] Although some criticise its ambiguous divide and the over simple equilibrium assumption,[240] the idea of the IPF is valuable, by a single criterion, in judging the performance of an economic system and in choosing the optimum institutional governance.[241] Given the above, this thesis incorporates the idea of IPF into the institutional comparison of the TCE, and the basic framework can be viewed as following Figure IV-2 reveals.

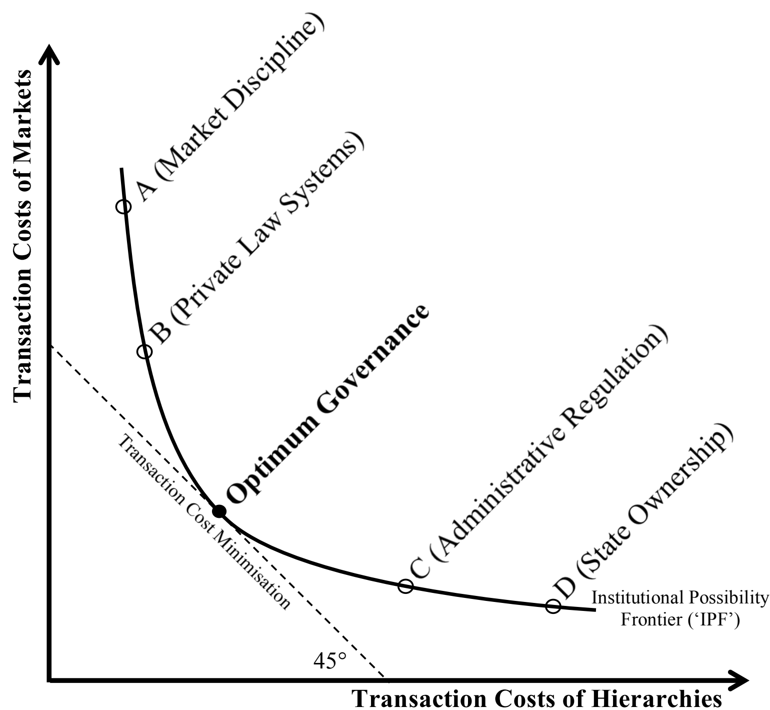

Figure IV-2: Basic Framework of Institutional Selection

Figure IV-2 depicts the IPF for the TCE analysis applied by this thesis. Market discipline and state ownership are two polar modes of governance alternatives, and private law systems and administrative regulation can be seen as two models between

239 Ibid, at 604–614.

240 Bruno Dallago, 'Comparative Economic Systems and the New Comparative Economics' (2004) 1 *The European Journal of Comparative Economics* 59, at 64–66; J. Barkley Rosser, Jr. and Marina V. Rosser, 'A Critique of the New Comparative Economics' (2008) 21 *Rev Austrian Econ* 81, at 83–88.

241 Peter J. Boettke et al, 'The New Comparative Political Economy' (2005) 18 *Rev Austrian Econ* 281, at 288–299; Josef C. Brada, 'The New Comparative Economics versus the Old: Less Is More but Is It Enough?' (2009) 6 *The European Journal of Comparative Economics* 3, at 8–11.

them.[242] Since every type of governance has its own organisational failures,[243] each of them may face transaction costs to different degrees. In order to show this difference, the horizontal and vertical axes of Figure IV-2 are set as transaction costs of hierarchies and of markets respectively. The TCE further appeals to the efficient alignment hypothesis to predict which transactions go—a 'transaction cost economising outcome'.[244] Therefore, the IPF is assumed to be convex to the origin, otherwise there would never be an optimum choice. The downward sloping 45 degree line in Figure IV-2 holds the minimum total transaction costs of markets and hierarchies, whose tangent with the IPF is the most efficient/optimum institutional choice. In this sense, the role of institutional selection is to make the best choice (i.e. the lowest total transaction costs) among these 'imperfect alternatives'.[245]

In order to illustrate this framework, we could suppose a society has four basic institutional strategies for governing investment conduct. First, the market discipline solution (Point A of Figure IV-2) relies on the demand/supply relationship between investment firms and their clients. However, as discussed above,[246] market discipline faces organisational failures that cause significant transaction costs, followed by a need for administrative regulation. The society can designate a regulatory authority, which mandates the way investment conduct is undertaken and penalises investment firms

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[242] Oliver E. Williamson, 'Comparative Economic Organization: The Analysis of Discrete Structural Alternatives' (1991) 36 *Administrative Science Quarterly* 269, at 279–281.

[243] O. E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications*, above note 10, at 21. See further in Section 2.2 above (pp. 137–142).

[244] Oliver E. Williamson, 'Transaction Cost Economics: The Natural Progression' (2010) 100 *The American Economic Review* 673, at 681.

[245] Neil K. Komesar, *Imperfect Alternatives: Choosing Institutions in Law, Economics, and Public Policy* (University of Chicago Press, 1996), at 3–6.

[246] See Section 3.1 above (pp. 146–153).

who break the rules. But, administrative regulation (Point C of Figure IV-2) itself also encounters organisational failures leading to transaction costs.[247] Therefore, the society still relies on private suits by clients who feel that they have been cheated by investment firms under the general doctrines of private law systems (Point B of Figure IV-2), as explored above.[248] The society, in this case, needs courts and judges and has to pay relative transaction costs for running them. In extreme cases, the society can even nationalise investment firms, and everything is under the control of the state (Point D of Figure IV-2). It should be emphasised that, as competition and regulation often operate in the same market, this classification does not mean these strategies are mutually exclusive, and an efficient institutional choice might be in the middle of them.[249] Therefore, from the normative perspective, the optimum institutional governance of investment conduct might be a combination of private law systems and administrative regulation,[250] namely, a point in somewhere between Point B and Point C of Figure IV-2. However, it might be difficult to find where this point exactly is.

4.2. Differences between Administrative Regulation and Private Law Systems

Given the long-standing distinction between public/private law,[251] it is irrefutable that administrative regulation and private law systems give rise to different rights, and are enforced by different authorities in governing investment conduct, as a 'two-tier

[247] See Section 3.2 above (pp. 153–161).
[248] See Section 3.3 above (pp. 161–169).
[249] A. Shleifer, above note 25, at 442–449.
[250] Richard A. Posner, 'Regulation (Agencies) versus Litigation (Courts): An Analytical Framework' in Daniel P. Kessler (ed), *Regulation versus Litigation: Perspectives from Economics and Law* (University of Chicago Press, 2011), at 22–24.
[251] See Section 3.3.3 above (pp. 165–167).

legal framework'.[252] This framework is underpinned by an institutional implication, that is: administrative regulation presupposes a leading and centralised role of administrative authorities in determining the legal position of a private person with regard to the whole society and to other private persons, whereas the heart of private law systems is to build a decentralised system with a aim of enabling private parties to order their relationships themselves.[253]

Differences can be found between these two tiers. First, compared to administrative authorities, courts are primarily concerned with settling disputes in individual cases triggered by private investors, rather than with the long-term social implications of their decisions on the whole market.[254] Given this case-by-case basis, the impact of private law systems is 'interstitial' instead of comprehensive.[255] Second, administrative regulation imposes positive obligations on authorised firms, which means the authorised firms are required to take action to discharge their obligations; while private law is normally reluctant to do so, unless the parties agree to these positive obligations by contracts.[256] The best execution requirement is an explicit example of such positive obligations imposed by regulatory rules.[257] Third, investment conduct regulation is applied *ex ante*, whereas general private law is largely applied *ex post* to

[252] O. O. Cherednychenko, above note 230, at 418–419.
[253] Olha O. Cherednychenko, *Fundamental Rights, Contract Law and the Protection of the Weaker Party: A Comparative Analysis of the Constitutionalisation of Contract Law, with Emphasis on Risky Financial Transactions* (Sellier, 2007), at 55.
[254] Alastair Hudson, *The Law of Finance* (2nd edn, Sweet & Maxwell, 2013), paras. 3-21–3-24; C. Scott, J. Black and R. Cranston, above note 204, at 517.
[255] Paul J Mishkin and Clarence Morris, *On Law in Courts: An Introduction to Judicial Development of Case and Statute Law* (Foundation Press, 1965), at 124; Martin Shapiro, *Courts: A Comparative and Political Analysis* (University of Chicago Press, 1986), at 28
[256] A. Hudson, above note 254, para. 10-07.
[257] Alastair Hudson, *Securities Law* (2nd edn, Sweet & Maxwell, 2013), para. 3-66. See further discussion of these obligations in Section 3.3 of CHAPTER II (pp. 32–61).

establish whether the violation of the standard of care by the investment firm has taken place in the circumstances of the individual case.[258] Administrative regulation, therefore, is to provide more clarity of investment firms concerning their obligations towards the client beforehand.

4.3. Complementarities between Administrative Regulation and Private Law Systems

Notwithstanding the above differences, administrative regulation and private law systems can still be mutually complementary in governing investment conduct. On the one hand, the ambit of private law duties is shaped by administrative regulation.[259] Administrative regulation imposes many duties on parties who are in privity with each other, which penetrate into private law systems and affect courts' decisions in cases[260]—the so-called 'osmosis',[261] 'external effect'[262] or 'radiating effect'.[263] First, administrative authorities may impose some mandatory provisions on contracts, causing a direct influence on contractual transactions and turning these private contracts into 'legal products' of regulation.[264] Second, since some general contractual duties are controlled by regulatory standards, private parties no longer need to bear various risks

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258 Olha O. Cherednychenko, 'European Securities Regulation, Private Law and the Investment Firm-Client Relationship' (2009) 5 *European Review of Private Law* 925, at 932–933.

259 Law Commission, Fiduciary Duties and Regulatory Rules: A Consultation Paper (Law Commission, 1992), paras. 5.4.23–5.4.29.

260 Danny Busch, 'Why MiFID Matters to Private Law—the Example of MiFID's Impact on An Asset Manager's Civil Liability' (2012) 7 *Capital Markets Law Journal* 386, at 390–413.

261 A. Hudson, above note 254, para. 3-31.

262 Susanne Kalss, 'Recent Developments in Liability for Nondisclosure of Capital Market Information' (2007) 27 *International Review of Law and Economics* 70, at 85–86.

263 Olha O. Cherednychenko, 'Private Law Discourse and Scholarship in the Wake of the Europeanisation of Private Law' in James Devenney and Mel Kenny (eds), *The Transformation of European Private Law: Harmonisation, Consolidation, Codification or Chaos?* (Cambridge University Press, 2013), at 158.

264 J. Köndgen, 'Policy Responses to Credit Crises: Does the Law of Contract Provide an Answer?', above note 184, at 39.

of litigating their cases in courts.[265] Even if there is no specific provision inside the contract, a common standard is given by this codification of administrative regulation in prescriptive detail;[266] even if there is an opt-out, via exclusion clauses within contracts, it is also restricted by administrative regulation.[267] However, it is still important to note that such radiating effect of administrative regulation, although it provides significant 'help' to private law systems, relies, nevertheless, on the gap-filling function of private law systems.[268]

Private law systems, on the other hand, also affect administrative regulation—as a 'two-way traffic'.[269] In practice, some discretionary decisions made by administrative authorities need the database of private law in order to decide the appropriate amount of fines, especially where such decisions depend on the amount of loss.[270] Principle-based regulatory standards can only be workable via more precedents in private law systems.[271] Many codes of administrative regulation in governing investment conduct are coming from major principles that private law systems have established:[272] fiduciary duties are a good example;[273] and 'undue influence' and 'integrity' also stimulate the development of administrative regulation.[274] In this sense, private law can

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265 Ibid, at 40.
266 Philip R. Wood, *Regulation of International Finance* (2nd edn, Sweet & Maxwell, 2007), para. 14-003.
267 Ibid. See further examples in Section 4.1.3 of CHAPTER V (pp. 219–221).
268 Brigitte Haar, 'From Public Law to Private Law: Market Supervision and Contract Law Standards' in Stefan Grundmann and Yesim M. Atamer (eds), *Financial Services, Financial Crisis and General European Contract Law: Failure and Challenges of Contracting* (Kluwer Law International, 2011), at 274–277.
269 Jenny Hamilton, 'Negligence in the Corridor? The Interaction between "Separate Rooms" of Regulation and the Common Law in Financial Services' (2007) 23 *Professional Negligence* 134, at 147.
270 Ibid, at 148.
271 A. Hudson above note 254, paras. 3-31–3-34.
272 See further in Section 4.2 of CHAPTER V (pp. 222–240).
273 Remus D. Valsan and Moin A. Yahya, 'Fiduciary Duties and Responsibilities of Portfolio Managers' in H. Kent Baker and Greg Filbeck (eds), *Portfolio Theory and Management* (Oxford University Press, 2013), at 166–180. See further in Section 4.2.3 of CHAPTER V (pp. 229–234).
274 A. Hudson, 'The Synthesis of Public and Private in Finance Law', above note 219, at 260–263.

function as 'the avant-garde in a risk society' due to its autonomy and flexibility, further leading to the metamorphosis of private law solutions into administrative regulation.[275]

On the whole, what we can see is a process of mutual learning and complementing occurring between private law systems and administrative regulation in governing investment conduct, as 'productive cherry-picking',[276] or 'mutual assisting legal orders'[277]—'different legal spaces superimposed, interpenetrated and mixed in our minds, as much as in our actions, either on occasions of qualitative leaps or sweeping crises in our life trajectories, or in the dull routine of eventless everyday life.'[278] This 'mutual permeation' is a good thing, because 'people who are in the same situation, irrespective of the legal area involved, receive equal treatment in the field of legal protection'.[279]

4.4. Difficult Choice in Transnational EU Markets

Given the differences and complementarities between these two types of governance, it is clear that the issue is not whether either one should have a role to play, but rather how, in effect, to reach a balance between private law systems and administrative regulation in governing investment conduct, and to create effective mechanisms for co-ordinating the roles of them.[280] This 'meta-legal' usage of

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[275] T. Wilhelmsson, above note 230, at 13–14.

[276] Julia Black, 'Law and Regulation: The Case of Finance' in Christine Parker et al (eds), *Regulating Law* (Oxford University Press, 2004), at 48–49.

[277] Jens-Peter Schneider, 'The Public-Private Law Divide in Germany' in Matthias Ruffert (ed), *The Public-Private Law Divide: Potential for Transformation?* (British Institute of International and Comparative Law, 2009), at 95–96.

[278] Boaventura de Sousa Santos, *Toward a New Legal Common Sense: Law, Globalization and Emancipation* (2nd edn, Butterworths LexisNexis, 2002), at 473.

[279] W. van Gerven, 'Mutual Permeation of Public and Private Law at the National and Supranational Level' (1998) 5 *Maastricht Journal of European and Comparative Law* 7, at 23–24.

[280] See further in Guido Ferrarini and Paolp Giudici, 'Financial Scandals and the Role of Private Enforcement: The Parmalat Case' in John Armour and Joseph A McCahery (eds), *After Enron: Improving*

administrative regulation and private law systems could be seen as a combination of two strategies for controlling misconduct in capital markets.[281] In relation to designing an optimal structure of intervention, the state has to decide the timing, the form and the initiation of intervention.[282] Some countries prefer to allocate the job to administrative authorities, whilst others to courts.[283] However, this decision might be much more difficult to be made in transnational markets (such as, the European capital markets). This is because, through the lens of governance, the control of global conduct cannot be adequately depicted as either national or transnational, public or private.[284]

On the one hand, as some describe, '[i]t could be very difficult to convince public officials or local bureaucrats to devote time and resources to complaints concerning foreign interests or values.'[285] The use of domestic administrative regulation for transnational markets is hampered by a lack of foreign vision and domestic interests embedded in regulatory processes.[286] Given this, the combination of domestic private law and private international law may provide better tools of governance than administrative regulation[287]—the so-called 'transnational private law'[288] emerges as a

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Corporate Law and Modernising Securities Regulation in Europe and the US (Hart Publishing, 2006), at 194–197.

281 Christopher D. Stone, 'Corporate Vices and Corporate Virtues: Do Public/Private Distinctions Matter?' (1982) 130 *University of Pennsylvania Law Review* 1441, at 1443 and 1451–1459.

282 Steven Shavell, *Foundations of Economic Analysis of Law* (Harvard University Press, 2004), at 575–581.

283 According to Köndgen, the German-speaking countries, relying on the doctrine of *culpa in contrahendo*, can enforce them without more through contractual liabilities, whilst the Angle-American tradition, where contract liabilities in contingent on a consideration given, lends itself more readily to administrative regulation. J. Köndgen, 'Policy Responses to Credit Crises: Does the Law of Contract Provide an Answer?', above note 184, at 45–56.

284 Peer Zumbansen, 'Neither 'Public' nor 'Private', 'National' nor 'International': Transnational Corporate Governance from a Legal Pluralist Perspective' (2011) 38 *Journal of Law & Society* 50, at 50–75.

285 Robert Wai, 'Transnational Private Law and Private Ordering in a Contested Global Society Symposium: Comparative Visions of Global Public Order' (2005) 46 *Harvard International Law Journal* 471, at 479.

286 Eleanor M. Fox, 'Global Markets, National Law, and the Regulation of Business: A View From the Top' (2012) 75 *St John's Law Review* 383, at 386–387.

287 This theory was formed in an early paper of Professor Wai: see R. Wai, 'Transnational Liftoff and Juridicial Touchdown: The Regulatory Function of Private International Law in an Era of Globalization',

better tool of transnational governance.[289] In fact, by means of distinguishing questions about jurisdiction and choices of law, private international law highlights an impressive tolerance and conditional cosmopolitan hospitality in the face of plural normative orders, with an emphasis on the role of contractual choices made by parties.[290] Transnational private law provides a softer function to a harmonisation of substantive law in the application of transnational markets.[291]

On the other hand, transnational private law has its limits too. This is because 'real conflicts' in transnational private law across jurisdictions expand significantly.[292] These 'real conflicts' are caused by different interests with individual, social and institutional concerns in transnational private law. Specifically, domestic private law may encounter significant obstacles to be transplanted and harmonised since it is more closely connected with traditional legal cultures.[293] Therefore, not only effective and credible operation of private law systems is necessary to administrative regulation,[294] but also transnational private law is underpinned by solid transnational administrative regulation.[295] In the practice of transnational governance, the relationship between

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above note 233, at 264–273.

288 The term of transnational private law was coined later in R. Wai, 'Transnational Private Law and Private Ordering in a Contested Global Society Symposium: Comparative Visions of Global Public Order', above note 285, at 478–479.

289 Robert Wai, 'Conflicts and Comity in Transnational Governance: Private International Law as Mechanism and Metaphor for Transnational Social Regulation Through Plural Legal Regimes' in Christian Joerges and Ernst-Ulrich Petersmann (eds), *Constitutionalism, Multilevel Trade Governance and Social Regulation* (Hart Publishing, 2006), at 247–251.

290 Robert Wai, 'The Interlegality of Transnational Private Law' (2008) 71 *Law and Contemporary Problems* 107, at 123–125.

291 Wolfgang Fikentscher, 'Harmonizing National and Federal European Private Laws, and a Plea for a Conflicts-of-law Approach' in Mauro Bussani and Ugo Mattei (eds), *The Common Core of European Private Law* (Kluwer Law International, 2003), at 43–49.

292 Joseph William Singer, 'Real Conflicts' (1989) 69 *Boston University Law Review* 1, Sec. III.

293 Pierre Legrand, *Fragments on Law-as-Culture* (W.E.J. Tjeenk Willink, 1999), at 113–115.

294 L. Casini, above note 213, at 35.

295 Fabrizio Cafaggi, 'New Foundations of Transnational Private Regulation' (2011) 38 *Journal of Law & Society* 20, at 43–45.

administrative regulation and private law systems is being transformed in a hybrid way (such as, trade associations now involve in enforcing and using powers delegated by legislative bodies).[296] This mix seeks to minimise transactions costs associated in transnational governance.[297] Yet, as Professor Cafaggi highlights, transnational governance of the pan-EU market is a much more complicated case: (i) there is a 'horizontal complementarity', when administrative regulation and private law systems operate at the same level, whether it is the EU level or the national level; and (ii) there is a 'vertical complementarity', where administrative regulation at the EU level and private law systems at the national level or *vice versa*; and these two types of complementarities then interact.[298] It is very difficult to make an optimal choice between administrative regulation and private law systems in governing investment conduct in the European capital markets.[299]

5. Institutional Change of Investment Conduct Governance

5.1. Basic Framework of Institutional Change

After the normative analysis of the institutional selection, the following question, from the positive viewpoint, is: how the society changes its governance if the current status is not optimum? As the TCE admits, institutional change is very likely to happen,

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[296] Colin Scott, Fabrizio Cafaggi and Linda Senden, 'The Conceptual and Constitutional Challenge of Transnational Private Regulation' (2011) 38 *Journal of Law & Society* 1, at 9–12.

[297] Geoffrey P. Miller, 'Financial Private Regulation and Enforcement' in Fabrizio Cafaggi (ed), *Enforcement of Transnational Regulation: Ensuring Compliance in a Global World* (Edward Elgar Publishing, 2012), at 277.

[298] Fabrizio Cafaggi, 'Private Regulation in European Private Law' in Arthur S. Hartkamp et al (eds), *Towards a European Civil Code* (4th edn, Kluwer Law International, 2011), at 100–101.

[299] Professor Cherednychenko summarises two forms of complementarity (i.e., co-regulation and meta-regulation) between administrative regulation and private law systems in the EU, and more research is needed into the effectiveness of such co-governance arrangements. See Olha O. Cherednychenko, 'Public and Private Financial Regulation in the EU: Opposites or Complements?' in Nicholas Dorn (ed), *Controlling Capital: Public and Private Regulation of Financial Markets* (Routledge, 2016), at 141–153.

since the *status quo* is only 'presumed to be efficient' to transactions.[300] The existence of governance 'tends' to economise transaction costs,[301] but there is no guarantee that the current system is the best, or always the best. However, institutional change was not the major focus of the TCE initially, so many critiques arose from this ignorance.[302]

In fact, institutional change represents the birth of a new type of governance, so the reasons for institutional change strongly relates to the reasons for the emergence of governance. Based on the divide of spontaneous/made orders used by Friedrich A. Hayek,[303] Professor Williamson argues that forms of governance could be either spontaneous or intentional: markets and hierarchies are polar examples of each, but there is always a mix in reality.[304] Thus, there are two polarised explanations of institutional change: on the one hand, institutional change may emerge from the unco-ordinated choices of many individuals, as a routine of natural evolution of institutions;[305] and, on the other hand, it may be argued that institutional change is

300 O. E. Williamson, 'Public and Private Bureaucracies: A Transaction Cost Economics Perspective', above note 71, at 316.

301 David M. Kreps, 'Markets and Hierarchies and (Mathematical) Economic Theory' (1996) 5 *Industrial and Corporate Change* 561, at 562.

302 For example, Professor Englander blames the TCE's reluctant acceptance of the role of technology in changing institutions: see Ernest J. Englander, 'Technology and Oliver Williamson's Transaction Cost Economics' 10 *Journal of Economic Behavior & Organization* 339, at 346–348. Another example is: Professor Dow highlights that the TCE ignores the influence of bounded rationality, learning effect and other human behaviour in changing institutions: see Gregory K. Dow, 'The Function of Authority in Transaction Cost Economics' (1987) 8 *Journal of Economic Behavior & Organization* 13, at 25–33.

303 Professor Hayek differentiates the 'spontaneous order' as a endogenous or self-generating order from the 'made order' as an exogenous order: see Friedrich A. Hayek, *Law, Legislation and Liberty*, vol 1: Rules and Order (University of Chicago Press, 1973), at 36–37.

304 Oliver E. Williamson, 'Economic Institutions: Spontaneous and Intentional Governance' (1991) 7 *Journal of Law, Economics, & Organization* 159, at 159–184.

305 See, e.g., Thorstein Veblen, *The Theory of the Leisure Class* (Oxford University Press's 2007 Reprinted edn, Macmillan, 1899), at 125; Richard R. Nelson and Sidney G Winter, *An Evolutionary Theory of Economic Change* (Harvard University Press, 1982), at 14–21; Margaret Levi, 'A Logic of Institutional Change' in Karen Schweers Cook and Margaret Levi (eds), *The Limits of Rationality* (University of Chicago Press, 1990), at 410; Jack Knight, 'Models, Interpretations and Theories: Constructing Explanations of Institutional Emergence and Change' in Jack Knight and Itai Sened (eds), *Explaining Social Institutions* (University of Michigan Press, 1995), at 107–110; H. Peyton Young, 'The Economics of Convention' (1996) 10 *The Journal of Economic Perspectives* 105, at 108–112; Thorbjørn Knudsen, 'Organizational Routines in

made deliberately by a centralised and collective-choice process.[306] These two polarised explanations of institutional change can further be used to discuss the reforms of financial regulation are either considered accidental or deterministic.[307] However, although each explanation could be fitted in some cases of institutional change, no explanation perfectly suits to all cases.[308] In the real world, the process of institutional change is generally a combination of 'artificial selection' and 'natural selection'.[309]

Given the institutional selection of investment conduct governance is a mix of (i) (market-oriented) private law systems, and (ii) (hierarchy-oriented) administrative regulation,[310] a broad framework of institutional change that integrates both of the above explanations is needed—that is, the equilibrium-of-game view of institutions.[311] This 'equilibrium view', based on the game theory[312], characterises institutions as the equilibrium of many 'games' in the society, no matter how this equilibrium is formed

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Evolutionary Theory' in Markus C. Becker (ed), *Handbook of Organizational Routines* (Edward Elgar, 2008), at 141–143.

306 See, e.g., Douglass C. North, *Structure and Change in Economic History* (Norton, 1981), Ch. 3; Gary D. Libecap, *Contracting for Property Rights* (Cambridge University Press, 1989), at 4–7; Lee J. Alston, 'Empirical Work in Institutional Economics: An Overview' in Lee J. Alston, Thrainn Eggertsson and Douglass C. North (eds), *Empirical Studies in Institutional Change* (Cambridge University Press, 1996), at 26–29; Shawn Everett Kantor, *Politics and Property Rights: The Closing of the Open Range in the Postbellum South* (University of Chicago Press, 1998), Ch.1.

307 See, e.g., Charles Goodhart, 'Financial Supervision from An Historical Perspective: Was the Development of Such Supervision Designed, or Largely Accidental?' in David Mayes and Geoffrey Wood (eds), *The Structure of Financial Regulation* (Routledge, 2005), at 43–64; Forrest Capie, 'Some Historical Perspective on Financial Regulation' in David Mayes and Geoffrey Wood (eds), *The Structure of Financial Regulation* (Routledge, 2005), at 69–85.

308 For a comprehensive literature review of this: see Christopher Kingston and Gonzalo Caballero, 'Comparing Theories of Institutional Change' (2009) 5 *Journal of Institutional Economics* 151, at 155–169.

309 Geoffrey M. Hodgson, 'John R. Commons and the Foundations of Institutional Economics' (2003) 37 *Journal of Economic Issues* 547, at 559–564.

310 See Section 4 above (pp. 169–179).

311 Rudolf Richter, *Essays on New Institutional Economics* (Springer, 2015), at 21–22.

312 Professor Myerson, who was awarded the Nobel Prize in Economics in 1991, defines the game theory 'as the study of mathematical models of conflict and cooperation between intelligent rational decision-makers': see Roger B. Myerson, *Game Theory: Analysis of Conflict* (Harvard University Press, 1997), at 1.

spontaneously or intentionally.[313] In these games, each player is constrained both by exogenous constraints that underlie games and by endogenous 'rules of the game' that reflect the strategies of the other players. Equilibrium is not static, which is influenced by not only exogenous causes (such as, technology improvements), but also endogenous causes (such as, learning effects).[314] This is the 'exogenous–endogenous duality' of institutions.[315] Institutional change, in this sense, could be seen as a path of seeking the dynamic equilibrium in the society. However, it is important to note that equilibrium is not necessarily efficient,[316] so there is no guarantee that the reformed governance of investment conduct is the most efficient one.

5.2. Types of Institutional Change and Path Dependence

Depending on the degree of changes, the types of institutional change can be classified into three categories: (i) persistence, which refers to an institutional system only accumulation of pressure for change; (ii) adaptation, which is to adjust the current

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313 See, e.g., David K. Lewis, *Convention: A Philisophical Study* (Harvard University Press, 1969), Ch. III; Andrew Schotter, *The Economic Theory of Social Institutions* (Cambridge University Press, 1981), Chs. 1–4; Randall Calvert, 'The Rational Choice Theory of Social Institutions: Cooperation, Coordination, and Communication' in Jeffrey S. Banks and Eric Allen Hanushek (eds), *Modern Political Economy: Old Topics, New Directions* (Cambridge University Press, 1995), at 216–260; Avner Greif, 'Self-Enforcing Political System and Economic Growth: Late Medieval Genoa' in Robert H. Bates et al (eds), *Analytic narratives* (Princeton University Press, 1998), at 22–63; Roger B. Myerson, 'Justice, Institutions, and Multiple Equilibria' (2004) 5 *Chicago Journal of International Law* 91, at 91–107; Avner Greif, *Institutions and the Path to the Modern Economy: Lessons from Medieval Trade* (Cambridge University Press, 2006), Ch. 5.

314 See, e.g., Masahiko Aoki, *Toward A Comparative Institutional Analysis* (The MIT press, 2001), Part II; Avner Greif and David D. Laitin, 'A Theory of Endogenous Institutional Change' (2004) 98 *The American Political Science Review* 633, at 639–640; A. Greif, ibid, Ch. 6; Masahiko Aoki, 'Endogenizing Institutions and Institutional Changes' (2007) 3 *Journal of Institutional Economics* 1, at 1–28; Masahiko Aoki, *Corporations In Evolving Diversity: Cognition, Governance, and Institutions* (Oxford University Press, 2010), Ch. 4.

315 Aoki, 'Endogenizing Institutions and Institutional Changes', ibid, at 10.

316 Brian R. Binger and Elizabeth Hoffman, 'Institutional Persistence and Change: The Question of Efficiency' (1989) 145 *Journal of Institutional and Theoretical Economics* 67, at 67–81. For example, the famous prisoner's dilemma game is a case of equilibrium which is not the Pareto efficiency. In the typical prisoner's dilemma, the 2x2 game is set up in such a way that each prisoner chooses to protect himself/herself at the expense of another prisoner. As a result of a logical decision-making process, both prisoners find themselves in a worse state than if they co-operate. See further in A. W. Tucker, 'The Mathematics of Tucker: A Sampler' (1983) 14 *The Two-Year College Mathematics Journal* 228, at 228.

institutional system in order to respond the pressure for change; and (iii) transformation, which is to create a new institutional system for the great pressure for change.[317] 'Surprises' are major exogenous causes of transformation.[318] An explicit example of this is the significant changes of financial regulation stimulated by the financial crisis of 2007–08. However, institutional change, in practice, is seldom reconstructive or deconstructive totally, and, normally, is 'overwhelmingly incremental'.[319] Persistence or adaptation happens in most cases, as history shows.[320] In the development of financial regulatory architecture, transformation seldom happens.[321]

In fact, no matter by which type of institutional change, institutional change represents a movement to reach dynamic equilibrium. In such a movement, endogenous causes of institutional change cannot be ignored. Previous institutional structures and past experience play an important role in reaching the equilibrium in novel situations.[322] Professor North provides a good description of this phenomenon:

> '[w]hen economists talk about their discipline as a theory of choice and about the menu of choices being determined by opportunities and preferences, they

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[317] Carl Folke et al, 'Resilience Thinking: Integrating Resilience, Adaptability and Transformability' (2010) 15 *Ecology and Society* 20, at 26; Elke Herrfahrdt-Pähle and Claudia Pahl-Wostl, 'Continuity and Change in Social-ecological Systems: the Role of Institutional Resilience' (2012) 17 *Ecology and Society* 8, at 8–11.

[318] Marco A. Janssen, 'A Future of Surprises' in Lance H. Gunderson and C. S. Holling (eds), *Panarchy: Understanding Transformations in Human and Natural Systems* (Island Press, 2002), at 250–251.

[319] D. C. North, *Institutions, Institutional Change and Economic Performance*, above note 45, at 89.

[320] For example, Frier and Kehoe illustrate the outcome of path dependence by three cases of the ancient economy in the agrarian history of the Roman empire: see Bruce W. Frier and Dennis P. Kehoe, 'Law and Economic Institutions' in Bruce W. Frier and Dennis P. Kehoe (eds), *The Cambridge Economic History of the Greco-Roman World* (Cambridge University Press, 2007), at 137–142.

[321] For example, Andreas and Donato conduct an empirical analysis, indicating that the relationship between the central bank's independence and the unification of financial supervisors' powers is largely limited by each country's former economic and institutional structures: see Andreas Freytag and Donato Masciandaro, 'Financial Supervision Architecture and Central Bank Independence' in Donato Masciandaro and Marc Quintyn (eds), *Designing Financial Supervision Institutions: Independence, Accountability and Governance* (Edward Elgar, 2007), at 211–261.

[322] Robert Sugden, 'Spontaneous Order' (1989) 3 *The Journal of Economic Perspectives* 85, at 88–90; A. Greif and D. D. Laitin, above note 314, at 636–638.

simply left out that it is the institutional framework which constraints people's choice sets.'[323]

Simply because 'history matters',[324] 'institutions lock in and reinforce historical outcome through endogenous institutional mechanisms'.[325] This is the so-called 'path dependence',[326] or 'lock-in',[327] effect of policy legacies. However, it is noteworthy that this path dependence 'is not "inertia," rather it is the constraints on the choice set in the present that are derived from historical experiences of the past'.[328] Path dependence, thus, does not always imply inefficiency.[329]

5.3. Self-Reinforcing of Investment Conduct Governance

Whilst some argue that path dependence is much less significant outside the market mechanism,[330] public policies and formal institutions are also 'change-resistant'.[331] Therefore, in the absence of significant exogenous causes like the financial crisis, the current system of investment conduct governance may easily persist. Any significant institutional change may face strong resistance if benefits of the change

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323 D. C. North, *Structure and Change in Economic History*, above note 306, at 201.

324 D. C. North, *Institutions, Institutional Change and Economic Performance*, above note 45, at 100; Sheri Berman, 'Path Dependency and Political Action: Reexamining Responses to the Depression' (1998) 30 *Comparative Politics* 379, at 380.

325 Tine Hanrieder, *International Organization in Time: Fragmentation and Reform* (Oxford University Press, 2015), at 29.

326 Professor David is the first one to use this term in analysing economic development in 1985: see Paul A. David, 'Clio and the Economics of QWERTY' (1985) 75 *The American Economic Review* 332, at 332–337.

327 This term was coined by Professor Arthur in 1989: see W. Brian Arthur, 'Competing Technologies, Increasing Returns, and Lock-In by Historical Events' (1989) 99 *The Economic Journal* 116, at 116–131.

328 Douglass C. North, *Understanding the Process of Economic Change* (Princeton University Press, 2005), at 52.

329 S. J. Liebowitz and Stephen E. Margolis, 'Path Dependence, Lock-in, and History' (1995) 11 *Journal of Law, Economics, & Organization* 205, at 206–208.

330 Stan J. Liebowitz and Stephen E. Margolis, 'Path Dependence' in Boudewijn Bouckaert and Gerrit De Geest (eds), *Encyclopedia of Law and Economics*, vol I: The History and Methodology of Law and Economics (Edward Elgar, 2000), at 994–995

331 Paul Pierson, 'Increasing Returns, Path Dependence, and the Study of Politics' (2000) 94 *The American Political Science Review* 251, at 257–262.

cannot be significantly proven.

First, large fixed costs of units are falling, and the learning effects are lowering costs within the current system over time,[332] so policymakers enjoy these benefits and lack motivation to change. Even if such decreasing effects are insignificant, policymakers may have *status quo* biases so that the current system of investment conduct governance could regularly produce one kind of outcome in favour of the extant winners.[333] Also, the losers lack incentives to change the current system, since they realise their small contribution has no perceptible impact.[334] This robust equilibrium between winners and losers insulates the current system of investment conduct governance from dissatisfaction and provides it with a measure of stability.[335]

Second, since the knowledge about institutional choices is incomplete, this uncertainty makes risk-averse policymakers stick to the current system of investment conduct governance, even when a better choice exists somewhere else.[336] It is also very difficult to ignore the effect of 'sunk costs' on policymakers' decision making.[337] Unlike fixed costs, sunk costs are retrospective costs that cannot be recovered (for example, specific skills or competences that can only be used in the current institutions), but people normally are motivated by them to adhere to their prior decisions.[338] These

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332 W. Brian Arthur, *Increasing Returns and Path Dependence in the Economy* (University of Michigan Press, 1994), at 112.

333 William H. Riker, 'Implications from the Disequilibrium of Majority Rule for the Study of Institutions' (1980) 74 *The American Political Science Review* 432, at 443; Vernon W. Ruttan, 'Social Science Knowledge and Induced Institutional Innovation: An Institutional Design Perspective' (2006) 2 *Journal of Institutional Economics* 249, at 257. See further in Section 3.2.3 above (pp. 157–159).

334 E. Thráinn, above note 16, at 64–67.

335 Kenneth A. Shepsle, 'Studying Institutions: Some Lessons from the Rational Choice Approach' (1989) 1 *Journal of Theoretical Politics* 131, at 142.

336 Philipp Genschel, 'The Dynamics of Inertia: Institutional Persistence and Change in Telecommunications and Health Care' (1997) 10 *Governance* 43, at 48.

337 Ibid, at 47.

338 See further examples in a well-known paper: Hal R. Arkes and Catherine Blumer, ' The Psychology of

'emotions' limit policymakers' willingness to change the current system of investment conduct governance.

5.4. Three Possibilities of Centralised Investment Conduct Supervision in the EU

On the basis of the foregoing discussion, a reform aiming to centralise investment conduct supervision means Member States have to transfer powers that they possess to the EU, which is a significant institutional change (namely, a transformation, or a big adaptation at least). On the one hand, incentives of centralising investment conduct supervision might be lowered since it is politically costly in terms of sovereignty loss or national champions' promotion, especially weakening the status of national supervisors.[339] If the benefits of this centralisation cannot be demonstrated, this change would face strong resistance caused by path dependence.[340] On the other hand, there is no guarantee that the current network-based system is the most efficient type of investment conduct governance either. In particular, many challenges to the current system have been recognised (such as, the institutional tension and weaknesses of ESMA).[341] In the light of these two sides, an institutional comparative analysis is useful and necessary to make sure that either the current network-based system or the centralised system of investment conduct supervision is more efficient than the other. Likewise, this comparison could provide a clear indication about the position of the

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Sunk Cost' (1985) 35 *Organizational Behavior and Human Decision Process* 124, at 124–140.

[339] A similar concern emerged during the consultation of establishing SSM in the EBU: see Gerard Hertig, Ruben Lee and Joseph A. McCahery, 'Empowering the ECB to Supervise Banks: A Choice-Based Approach' (2010) 7 *European Company & Financial Law Review* 171, at 184.

[340] See further in Sections 5.2 and 5.3 above (pp. 182–186).

[341] See further in Section 4 of CHAPTER II (pp. 61–71) and CHAPTER III (pp. 105–128).

current system, so that responding reforms towards the optimum investment conduct governance could be designed. Based on the transaction cost approach established above, the result of this comparison has three possibilities, as shown in the following Figures.

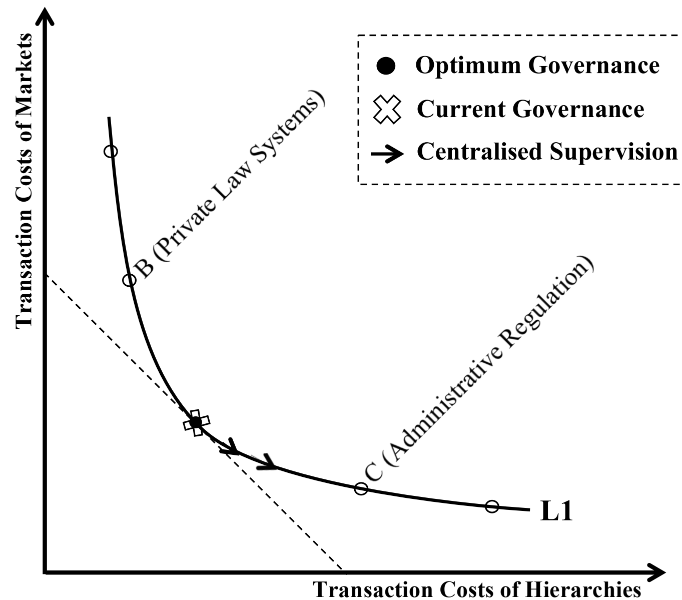

Figure IV-3: Possibility 1 of Centralised Investment Conduct Supervision in the EU

First of all, assume that the optimum governance of investment conduct in the EU is a point (●) somewhere between private law systems (Points B) and administrative regulation (Point C) on the IPF. And the current network-based system of investment conduct governance in the EU is at a point (✠). In terms of the reform aiming to centralise investment conduct supervision, it is an institutional change towards a higher extent of administrative regulation (⟶). Based on this assumption, if the current system is the most efficient one in accordance with the TCE, the two points (namely, ● and ✠) will match at the same place. In this possibility, the reform of centralisation departs from the lowest-transaction-costs point, as the line L1 in above Figure IV-3

shows. The path dependence resisting the change, thus, secures the efficient outcome. But, it is highly impossible that the current system is as perfect as this, given the challenges we examined.[342] In reality, the point of the current system could be possibily either on the right side or on the left side of the optimum point, as the following possibilities 2 and 3.

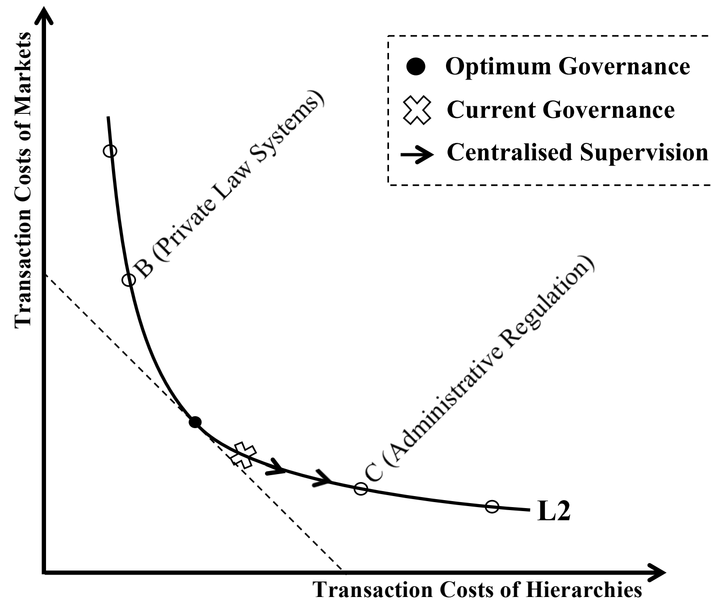

Figure IV-4: Possibility 2 of Centralised Investment Conduct Supervision in the EU

If the point of the current system (✠) is on the right side of the optimum point (●), the relationship between the current system and the reform of centralisation could be viewed as the above Figure IV-4 shows. Similar to the line L1, the reform of centralisation (⟶) moves to the wrong direction, followed by an increase of total transaction costs. If the point of the current system (✠) is on the left side of the optimum point (●), the centralisation of investment conduct supervision (⟶) might bring three possible sub-outcomes, as Figure IV-5 reveals below.

[342] See further in Section 4 of CHAPTER II (pp. 61–71) and CHAPTER III (pp. 105–128).

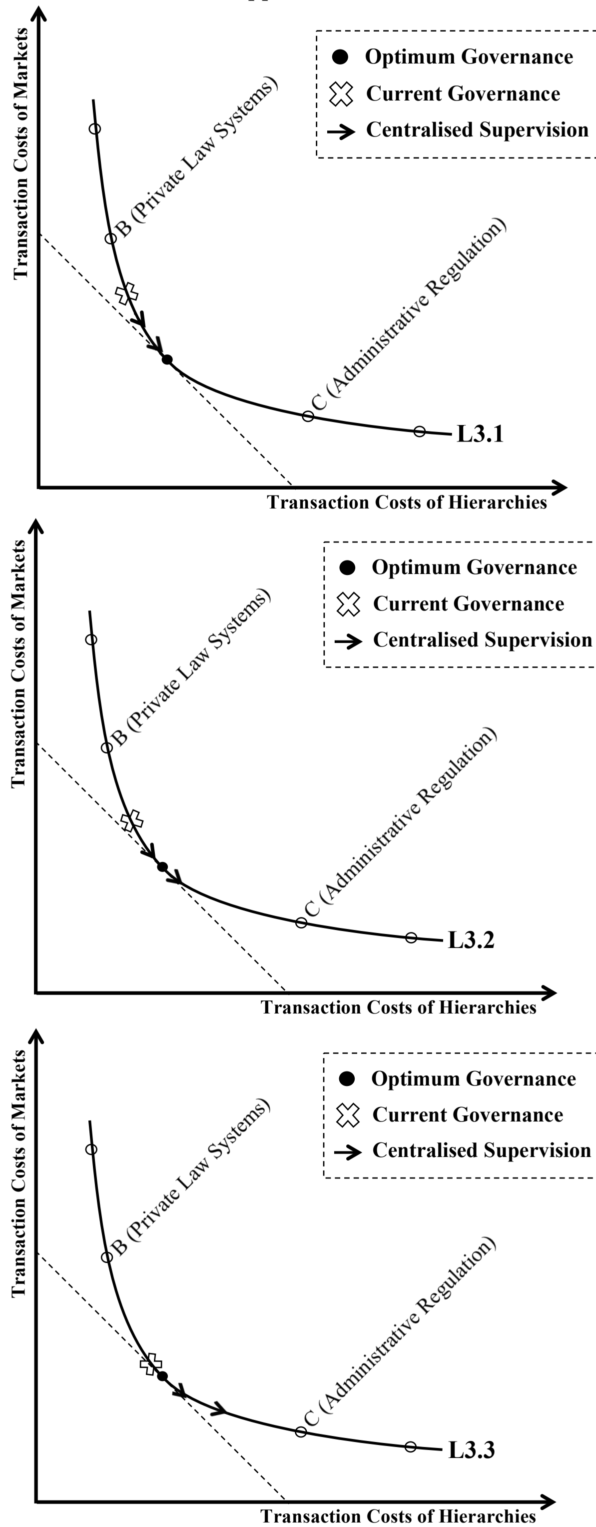

Figure IV-5: Possibility 3 of Centralised Investment Conduct Supervision in the EU

In these cases, the direction of institutional change is correct, since that all changes are moving towards the optimum point. Ideally, as line L3.1, an institutional change

makes the point of the current system close to the optimum point, leading to a significant reduction of total transaction costs. However, an institutional change may move 'too much' and over the optimum point. As showed by lines L3.2 and L3.3 respectively, an over movement would increase the total transaction costs again and even exceed the previous number of total transaction costs.

Given these possibilities, an institutional comparison between the current system and the reform of centralisation is useful to confirm the relative positions of them and, most importantly, to find out the optimum point. Due to the fact that the above possibilities are on the interval of IPF between private law systems and administrative regulation, this institutional comparision shall include both the transaction costs of these two types of governance. Based on the outcome of this comparison, if the total transaction costs decrease after the reform of centralised supervision, the positions of them may look like lines L3.1 or L3.2; and, on the contrary, they may be more like the lines L2 or L3.3 if the total transaction costs increase. Technically, there is another possible outcome of the institutional comparison: namely, the sum of total transaction costs remains the same. In this situation, the optimum point is in the middle of the current system and the reformed system. However, given the difficulty of quantifying transaction costs, it is extremely difficult to obtain such an outcome by the institutional comparison. Moreover, from the positive viewpoint, path dependence resists institutional changes no matter in which case,[343] so, without a significant reduction of the total transaction costs as lines L3.1 or L3.2 show, the reform to centralising

[343] See further in Sections 5.2 and 5.3 above (pp. 182–186).

investment conduct is unnecessary and unfeasible to the CMU. In other words, if there is no significant decrease of the total transaction costs based on the outcome of an institutional comparison, the answer of the research question is negative otherwise.

6. Concluding Remarks

This chapter has established the theoretical foundations of the transaction cost approach. The rationales and forms of investment conduct governance have also been identified. Based on this approach, market discipline, administrative regulation and private law systems all are types of investment conduct governance for reducing transaction costs. However, all of them face the issues of organisational failures, causing transaction costs to different extents. Therefore, no type of investment conduct governance is perfect, as transaction costs cannot be eliminated entirely, and there is no guarantee that either the current status or any proposed reform is the optimum one. What we can do is try to find a comparatively 'better' arrangement among the different types of investment conduct governance, in order to minimise the total transaction costs.

In order to find an institutional solution to minimise the total transaction costs, the framework of institutional selection has also been established in this chapter. This framework not only summarises four basic forms of governance (i.e., market discipline, private law systems, administrative regulation and state ownership), but also opens a broad set of institutional solutions for investment conduct governance. By following the clear indication of choosing the optimum investment conduct governance provided by the IPF, private law systems and administrative regulation are taken into account

simultaneously. Furthermore, due to the fact that the current status of investment conduct governance is very unlikely to be optimum, the framework of institutional change is useful to explain the causes and process of any institutional reform in the real world. This framework highlights an important inequality between 'efficient' and 'equilibrium', and 'path dependence' might be the major resistance of any big reform. On the whole, the transaction cost approach not only establishes a standard for the institutional selection and comparison, but also provides an indication of institutional change based on the results of the institutional comparison. By the sound of this, the research question—whether investment conduct should be supervised centralisedly at the EU level in the CMU—could be answered by a comprehensive institutional comparison, from the perspective of private law systems and administrative regulation respectively.

CHAPTER V

OPTIMUM PRIVATE LAW GOVERNANCE OF INVESTMENT CONDUCT IN THE CAPITAL MARKETS UNION

'The "Internal Market" (the EU multilevel system, the Economic and Political European Constitution), that I have in mind would be a co-ordination system of different visible hands [including European private law and national private legal orders] which combines aspects of efficiency with those of material justice and which does not only distribute competences between the European Community, the Member States (and private actors), but delimit them.'[1]

1. Introduction

Based on the transaction cost approach set out in the last chapter, this chapter is going to examine the private law governance of investment conduct in the EU. As one commentator claims: '[i]n contrast to nominal separation, the CMU announces an in-principle public-private symbiosis of financial markets regulation, with public and private regulators inviting each other to articulate a co-governance space'.[2] The CMU's policy implication indeed reveals an important role for private law systems in the European capital markets integration.[3] According to the model of 'Eurolegalism', it is

[1] Hans-W Micklitz, 'The Visible Hand of European Regulatory Private Law—The Transformation of European Private Law from Autonomy to Functionalism in Competition and Regulation' (2009) 28 *Yearbook of European Law* 3, at 59.

[2] Nicholas Dorn, 'Capital Cohabitation: EU Capital Markets Union as Public and Private Co-Regulation' (2016) 11 *Capital Markets Law Journal* 84, at 85.

[3] Fabrizio Cafaggi, 'A Coordinated Approach to Regulation and Civil Liability in European Law: Rethinking Institutional Complementarities' in Fabrizio Cafaggi (ed), *The Institutional Framework of European Private Law* (Oxford University Press, 2006), at 195–199. See further in Section 4.3 of CHAPTER II (pp. 68–71).

also argued that the EU regime for investment services is developing towards regulation by 'litigation',[4] which would bring the EU closer to an adversarial, judicialised approach with an increasing emphasis on its private law system.[5] Therefore, when considering whether the CMU needs a centralised administrative authority in charge of investment conduct supervision, it is inevitable to compare transaction costs, from the perspective of private law systems, before and after this proposed reform. If transaction costs will not be reduced after the introduction of a single supervisor in charge of investment conduct supervision, this may provide an argument against further centralisation. However, private law systems in governing investment conduct in the EU are very complex, so this comparison shall be based on a comprehensive analysis of MiFID's influence on national private law, the role of national private law and the function of the intra-European private international law.

In order to do so, the remainder of this chapter falls into five sections. The first of these, Section 2, discusses the development of European private law and Treaty limitations on it. Section 3 examines the private law nature of the MiFID regime. The interaction between MiFID's rules (as European private law) and national private law is further discussed in Section 4, on the basis of the UK position (and, in particular, English law, given London currently is still a leading financial centre in the EU). This discussion indicates some unresolved issues of the current private law systems in governing investment conduct in the EU. In Section 5, a number of critical thoughts for tackling such issues in the CMU are analysed, which includes ideas on the further

[4] R. Daniel Kelemen, *Eurolegalism: The Transformation of Law and Regulation in the European Union* (Harvard University Press, 2011), at 115, 138–142.
[5] Ibid, at 96–97.

centralising of investment conduct supervision and establishing a pan-EU extra-judicial mechanism. In the final section, Section 6, conclusions of this chapter are drawn.

2. European Private Law and European Integration

2.1. Late Development of European Private Law

Originally, the Treaty of Rome in 1957, signed by six European nations, was 'exclusively public in inspiration and scope'.[6] This is because the primary focus of the internal market, at that moment, was the abolition of tariffs and custom duties, which could be achieved without reference to the civil codes. Given a similar reason that the first purpose of capital markets legislation in the EU is not to deal with relations among investors, the development of instrumentalised private law in the investment firm/client relationship was comparatively late at the EU level.[7] However, the 'de-couplings' of the European regulatory system from national private law systems 'produces ever more disintegrative side-effect' on the internal market policy.[8] This segregation, thus, begins to buckle under heavy pressure from functionalists. The rationale behind this pressure is that EU law shall be applied and implemented in a uniform manner throughout the internal market, irrespective of how Member States conceive of the concepts of regulation, or of the public/private law divide.[9] This pressure is becoming more and

[6] Daniela Caruso, 'The Missing View of the Cathedral: The Private Law Paradigm of European Legal Integration' (1997) 3 *European Law Journal* 3, at 9.
[7] Eddy Wymeersch, 'Private Law Remedies Relating to Obligations Flowing From EU Directives on Securities' in Matti Rudanko and Pekka Timonen (eds), *European Financial Area* (Institute of International Economic Law (KATTI), 1996), at 203.
[8] Christian Joerges, 'On the Legitimacy of Europeanising Private Law: Considerations on a Law of Justi(ce)-fication (Justum Facere) for the EU Multi-Level System' in Arthur Hartknamp et al (eds), *Towards a European Civil Code* (3rd edn, Kluwer Law International, 2004), at 172.
[9] Constanze Semmelmann, *The Public-Private Divide in European Union Law or an Overkill of Functionalism* (Maastricht European Private Law Institute Working Paper No 2012/12, 2012), at 13–14. See further in Article 288 of TFEU and Section 3.1 below (pp. 200–201).

more strong under the trend of internationalisation and globalisation.[10] Therefore, European legislation starts to 'instrumentalise' rules of private law.[11] This is the so-called 'goal-oriented private law',[12] or 'regulatory private law'.[13] Private law now has a prominent 'state-making' role in the EU.[14]

Given this on-going change, it can be very difficult to assign any given provision of the EU law to either private law or administrative regulation in the current state of development.[15] Primary and secondary laws in the EU now are organised along the lines of the overall objective of market integration as reflected in the different subject matters, functionally.[16] The split between public law and private law is abandoned by EU legislation.[17] For example, it is not unusual that specific duties of investment firms, whether contractual or non-contractual, are imposed simultaneously by general private

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[10] Inger-Johanne Sand, 'Globalization and the Transcendence of the Public/Private Divide—What is Public Law under Conditions of Globalization?' in Cormac Mac Amhlaigh, Claudio Michelon and Neil Walker (eds), *After Public Law* (Oxford University Press, 2013), at 208–210.

[11] Christian Joerges, 'The Challenges of Europeanization in the Realm of Private Law: A Plea for a New Legal Discipline' (2004) 14 *Duke Journal of Comparative and International Law* 149, at 183.

[12] Fabrizio Cafaggi and Horatia Muir Watt, *The Making of European Private Law: Regulation and Governance Design* (European Governance Papers No N-07-02, 2007), at 12.

[13] H.-W. Micklitz, above note 1, at 6–7. For a detailed comparison between European private law and national private law: see Ralf Michaels, 'Of Islands and the Ocean: The Two Rationalities of European Private Law' in Roger Brownsword et al (eds), *The Foundations of European Private Law* (Hart Publishing, 2011), at 144–149.

[14] Daniela Caruso, 'Private Law and State-Making in the Age of Globalization' (2006) 39 *New York University Journal of International Law and Politics* 1, at 24–26 and 31–33.

[15] Michael Dougan, 'Who Exactly Benefits From The Treaties? The Murky Interaction Between Union And National Competence Over The Capacity To Enforce EU Law' (2010) 12 *Cambridge Yearbook of European Legal Studies* 73, at 77; Hugh Collins, 'The Hybrid Quality of European Private Law' in Roger Brownsword et al (eds), *The Foundations of European Private Law* (Hart Publishing, 2011), at 453; Michel Rosenfeld, 'Rethinking the Boundaries between Public Law and Private Law for the Twenty First Century: An Introduction' (2013) 11 *International Journal of Constitutional Law* 125, at 126;

[16] For an analysis of the EU's primary law: see Okeoghene Odudu, 'The Public/Private Distinction in EU Internal Market Law' (2010) 46 *Revue trimestrielle de droit europeen* 826, at 826–841; for an analysis of the EU's secondary law: see Norbert Reich, 'The Public/Private Divide in European law' in Hans-W. Micklitz and Fabrizio Cafaggi (eds), *European Private Law after the Common Frame of Reference* (Edward Elgar, 2010), at 56–89.

[17] Fabrizio Cafaggi and Horatia Muir Watt, 'Introduction' in Fabrizio Cafaggi and Horatia Muir Watt (eds), *The Regulatory Function of European Private Law* (Edward Elgar, 2009), at xi. For a similar discussion from the international viewpoint: see Mahmood Bagheri and Chizu Nakajima, 'International Securities Markets, the Diversity of National Regulations and the Relevance of the Public/Private Law Dichotomy' (2001) 3 *International and Comparative Corporate Law Journal* 49, at 49–75.

law, and by rules of administrative regulation in different jurisdictions in the EU.[18] The blurring between private law systems and administrative regulation (and even combinations of both) does not present serious problems, but complementarities in the EU.[19] This also proves that the European law is essentially a 'law of governance' and European private law is just one form of this governance, according to the transaction cost approach established in the last chapter.[20]

2.2. Treaty Limitations on Harmonisation of European Private Law

Despite some commentators claiming that the harmonisation of private law in international capital markets is more likely to happen than administrative regulation,[21] this may not be the case in the European private law. Unlike Article 83.2 of the TFEU that provides a legitimate competence for the EU to impose harmonisation policy of criminal law, there is no clear provision in the EU Treaties for harmonising private law in the EU.[22] European private law, thus, is formed by a decentralised mode and the EU only has limited powers in this field. To some extent, this decentralised system is designed to find a dynamic balance between: (i) the wills of Member States to defend their sovereign justice, and (ii) their need to find institutional answers to transnational

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[18] Apostolos Gkoutzinis, 'Free Movement of Services in the EC Treaty and the Law of Contractual Obligations relating to Banking and Financial Services' (2004) 41 *Common Market Law Review* 119, at 167.
[19] Wolfgang Kerber, 'European System of Private Laws: An Economic Perspective' in Fabrizio Cafaggi and Horatia Muir-Watt (eds), *Making European Private Law: Governance Design* (Edward Elgar Publishing, 2010), at 70. See further in Section 4.3 of CHAPTER IV (pp. 174–176).
[20] See further in Section 4.4 of CHAPTER IV (pp. 176–179).
[21] See, e.g., M. Bagheri and C. Nakajima, above note 17, at 64–65.
[22] There is no article like Article 83.2 of the TFEU that provides for the EU's competence to impose harmonisation policy of criminal law. For further discussion regarding this issue: see Jacobien W. Rutgers, 'European Competence and a European Civil Code, a Common Frame of Reference or an Optional Intrument' in Arthur S. Hartkamp et al (eds), *Towards a European Civil Code* (4th edn, Kluwer Law International, 2011), at 313–328.

litigation within the process of EU integration.[23] In accordance with Article 81 of the TFEU,[24] it requires the EU to develop judicial 'cooperation' in civil matters having cross-border implications 'particularly when necessary for the proper functioning of the internal market'.[25] However, in many cases, it is hard to assess the impact of the absence of such uniform system of private law on intra-European trade,[26] but, in the presence of highly harmonised private law systems, the possibility of undermining the domestic law of Member States might be easily proven.[27] Likewise, even though the term 'cooperation' may include 'measures for the approximation',[28] Article 81, unlike the breadth of Article 114, lists the measures that can be adopted exhaustively.[29]

Therefore, in the absence of a treaty amendment, private law systems will continue to represent a major sensitivity for Member State/EU separation of powers.[30] The core

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[23] Mattia Magrassi, 'Reconsidering the Principle of Separation of Powers: Judicial Networking and Institutional Balance in the Process of European Integration' (2011) 3 *Contemporary Readings in Law and Social Justice* 159, at 175–176.

[24] It should be noted that not all Member States are bound by this Article. Denmark, the UK and Ireland can decide to opt in (or out) of relative policies based on this Article: see Protocol (No 21) on the position of the United Kingdom and Ireland in respect of the area of freedom, security and justice, 2008 OJ C115/295; and Protocol (No 22) on the position of Denmark, 2008 OJ C115/299.

[25] Article 81.2 of the TFEU.

[26] Martin Boodman, 'The Myth of Harmonization of Laws' (1991) 39 *The American Journal of Comparative Law* 699, at 715–716; Gerhard Wagner, 'The Economics of Harmonization: the Case of Contract Law' (2002) 39 *Common Market Law Review* 995, at 1006–1018.

[27] HM Government, Review of the Balance of Competences between the United Kingdom and the European Union: Civil Judicial Cooperation, February, 2014, para. 2.13, available at: <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/279228/civil-judicial-cooperation-report-review-of-balance-of-competences.pdf> (accessed June, 2016).

[28] Article 81.1 of the TFEU.

[29] Article 81.2 lists eight measures exhaustively: '(a) the mutual recognition and enforcement between Member States of judgments and of decisions in extrajudicial cases; (b) the cross-border service of judicial and extrajudicial documents; (c) the compatibility of the rules applicable in the Member States concerning conflict of laws and of jurisdiction; (d) cooperation in the taking of evidence; (e) effective access to justice; (f) the elimination of obstacles to the proper functioning of civil proceedings, if necessary by promoting the compatibility of the rules on civil procedure applicable in the Member States; (g) the development of alternative methods of dispute settlement;(h) support for the training of the judiciary and judicial staff.'

[30] Niamh Moloney, 'Effective Policy Design for the Retail Investment Services Market: Challenges and Choices Post FSAP' in Guido Ferrarini and E. Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond* (Oxford University Press, 2006), at 425; Christian Twigg-Flesner, 'Introduction: Key Features of European Union Private Law' in Christian Twigg-Flesner (ed), *The Cambridge Companion to European Union Private Law* (Cambridge University Press, 2010), at 14–18.

of private law systems in Member States has to remain in the hands of national institutions with autonomy—as 'a sort of antidote to the dilution of regional identities'.[31] In order to find a compromise of various legal cultures in private law in Member States,[32] soft methods or harmonisation of non-core and commonly agreed elements might be more feasible in the practice of the European private law.[33] Compared to regulatory rules, there may not be a high level of harmonisation of private law systems regarding financial services in the EU.[34] This also explains why the Lamfalussy process is much determined by way of regulatory rules and leaves a free forum to national private law.[35]

3. MiFID Functioning as European Private Law

3.1. MiFID's Influence on National Private Law

When considering private law systems in governing investment conduct in the EU, the first question is whether MiFID's rules have influence on national private law. Indeed, on the basis of the Lamfalussy structure, MiFID's rules are predominantly

[31] D. Caruso, 'The Missing View of the Cathedral: The Private Law Paradigm of European Legal Integration', above note 6, at 4.
[32] Lorenz Kähler, 'Conflict and Compromise in the Harmonization of European Law' in Thomas Wilhelmsson, Elina Paunio and Annika Pohjolainen (eds), *Private Law and the Many Cultures of Europe* (Kluwer Law International, 2007), at 135–139.
[33] Peter Rott, 'Effective Enforcement and Different Enforcement Cultures in Europe' in Thomas Wilhelmsson, Elina Paunio and Annika Pohjolainen (eds), *Private Law and the Many Cultures of Europe* (Kluwer Law International, 2007), at 312–315, 318–321. For example, some plan a similar policy of the Principles of European Law for Financial Service Contracts ('PELFSC'), but in a softer way of the Common Frame of Reference ('CFR'): see Olha O. Cherednychenko and Chris E.C. Jansen, 'Principles of European Law on Financial Service Contracts?' (2008) 16 *European Review of Private Law* 443, at 443–468. Some suggest that an EU Investment Law Acquis Database should be established: see Niamh Moloney, 'Liability of Asset Managers: A Comment' (2012) 7 *Capital Markets Law Journal* 414, at 422.
[34] Olha O. Cherednychenko, 'Full Harmonization of Retail Financial Services Contract Law in Europe: A Success or a Failure?' in Stefan Grundmann and Yesim M. Atamer (eds), *Financial Services, Financial Crisis and General European Contract Law: Failure and Challenges of Contracting* (Kluwer Law International, 2011), at 226–227.
[35] Hans-W. Micklitz, 'Regulatory Strategies on Services Contracts in EC Law' in Fabrizio Cafaggi and Horatia Muir Watt (eds), *The Regulatory Function of European Private Law* (Edward Elgar, 2009), at 27–29. See further in Section 3.1 of CHAPTER II (pp. 23–27).

designed to harmonise rules of administrative regulation in Member States.[36] But, the MiFID regime does not prohibit Member States from considering the private law nature of its rules, even though it may not have the intention to do so.[37] Theoretically, the MiFID regime has three possible ways to affect private cases as follows.

First, MiFID's investment conduct rules could be transposed into national private law systems. According to Article 288.3 of the TFEU, '[a] Directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.' In the absence of any clear provision, Member States could freely use different ways (whether by administrative rules or private law) to transpose MiFID's rules into their national legal systems, provided that they could ensure that infringements are penalised in an 'effective, proportionate and dissuasive' way.[38] However, it is needed to remind two limits on this transposition if Member States decide to transpose MiFID's investment conduct rules into their national private laws: (i) this transposition is subject to the principles of equivalence and effectiveness, namely, the national remedies and procedures 'are not less favourable than those governing similar domestic actions' and they do not make the exercise of rights conferred by the EU legal order 'practically impossible or excessively difficult';[39] and (ii) this transposition shall not endanger the

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36 See further in Section 3.3 of CHAPTER II (pp. 32–61).
37 See further in Section 4.3 of CHAPTER II (pp. 68–71).
38 CJEU, Case 68/88, *Commission of the European Communities v Hellenic Republic*, [1989] ECR 2965, para. 24; CJEU, Case C-326/88, *Anklagemyndigheden v Hansen & Soen I/S*, [1990] ECR I-2911, para. 17.
39 See, e.g., CJEU, Joined cases C-397/98 and C-410/98, Metallgesellschaft and Others, [2001] ECR I-1727, para. 85; C-147/01, *Weber's Wine World and Others*, [2003] ECR I-11365, para. 103; C-291/03, *MyTravel*, [2005] ECR I-8477, para. 17; Case C-591/10, *Littlewoods Retail and Others*, [2012] ECLI:EU:C:2012:478, para. 27. For a comprehensive discussion of the principles of equivalence and effectiveness: see Michael Dougan, 'The Vicissitudes of Life at the Coalface: Remedies and Procedures for Enforcing Union Law before the National Courts' in Paul P. Craig and Gráinne De Búrca (eds), *The*

effective judicial protection of Member States required by Article 19.1 of the TEU and Article 47 of the Charter of Fundamental Rights of the European Union.[40]

Second, MiFID's investment conduct rules may have some influence on the client/investment firm relationships, regardless of the fact that these rules are transposed into national regulatory rules or private law. In accordance with the settled CJEU case law, Directives are addressed exclusively to Member States and do not have a 'horizontal direct effect' on individuals, i.e., a Directive 'cannot of itself impose obligations on an individual and cannot therefore be relied on as such against an individual'.[41] Nevertheless, according to Article 4.3 of the TEU, Member States 'shall take any appropriate measure, general or particular, to ensure fulfilment of the obligations arising out of the Treaties or resulting from the acts of the institutions of the Union'. This obligation is also binding on national courts of Member States, so national courts are required to interpret national law 'in the light of the wording and purpose' of EU Directives in order to ensure the full effectiveness of EU law.[42] This is the so-called 'horizontal indirect effect'.[43] By means of this, 'effective' MiFID's rules could have an

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Evolution of EU Law (Oxofrd University Press, 2011), at 407–438.

[40] For critical analyses of the relationship between the principle of effectiveness and the effective judicial protection: see Sacha Prechal and Rob Widdershoven, 'Redefining the Relationship between 'Rewe-effectiveness' and Effective Judicial Protection' (2011) 4 *Review of European Administrative Law* 31, at 38–49; Marek Safjan and Dominik Düsterhaus, 'A Union of Effective Judicial Protection: Addressing a Multi-level Challenge through the Lens of Article 47 CFREU' (2014) 33 *Yearbook of European Law* 3, at 9–26.

[41] CJEU, Case 152/48, *Marshall v Southampton and South-West Hampshire Area Health Authority*, [1986] ECR 723, para. 48; Case C-91/92, *Faccini Dori v Recreb*, [1994] ECR I-3325, para. 20; Case C-192/94, *El Corte Inglés v Blázquez Rivero*, [1996] ECR I-1281, para 15; Case C-201/02, *Wells v Secretary of State for Transport, Local Government and the Regions*, [2004] ECR I-23, para. 56; Joined Cases C-397/01 to C-403/01, *Pfeiffer et al v Deutsches Rotes Kreuz et al*, [2004] ECR I-8835, para. 108; and Case C-555/07, *Kücük- deveci v Swedex GmbH & Co. KG*, [2010] ECR I-00365, para. 46.

[42] CJEU, Case 14/83, *Von Colson and Kamann v Land Nordrhein-Westfalen*, [1984] ECR 1891, para. 26; Case C-106/89, *Marleasing v Comercial Internacional de Alimentación*, [1990] ECR I-4135, para. 8; Case C-334/92, *Wagner Miret v Fondo de garantía salarial*, [1993] ECR I-6911, para. 20; Case C-131/97, *Carbonari and Others*, [1999] ECR I-1103, para. 48; Case C-62/00, *Marks & Spencer*, [2002] ECR I-6348, para. 24

[43] In fact, there is a debate about the difference between the terminologies of 'horizontal direct/indirect

influence on the courts' interpretation of national law at least, or even lead to similar results which would be achieved if the Directives were capable of producing a horizontal effect in the case law system.[44] Having said that, this effect is not without restrictions: (i) such an interpretation cannot determine nor aggravate the criminal liabilities of persons who act in contravention of that Directive's provisions;[45] and (ii) national courts have to consider national law as a whole (namely, 'on the basis of all provisions of national law') in order to assess to what extent it may be applied, so as not to produce a result contrary to that sought by the Directive.[46]

Third, national regulatory rules transposing MiFID's investment conduct rules could influence judgements in private law cases. For example, by taking into account of the aim of investor protection, many scholars suggest that the burden of proof should be reversed in serious violations of the investment services providers' obligations under the MiFID regime.[47] However, there is no consistent approach between national courts

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effect' and 'direct/indirect horizontal effect'. However, this is outside the scope of this study, and does not affect the analysis below; this study applies the former since it is the usual one in the EU law. For further information regarding this debate: see Arthur Hartkamp, 'The Effect of the EC Treaty in Private Law: On Direct and Indirect Horizontal Effects of Primary Community Law' (2010) 18 *European Review of Private Law* 527, at 527–548; and Christiaan Timmermans, 'Horizontal Direct/Indirect Effect or Direct/Indirect Horizontal Effect: What's in a Name?' (2016) 24 *European Review of Private Law* 673, at 673–685.

[44] Takis Tridimas, 'Black, White, and Shades of Grey: Horizontality of Directives Revisited' (2001) 21 *Yearbook of European Law* 327, at 347–348; Paul Craig, 'The Legal Effect of Directives: Policy, Rules and Exceptions' (2009) 34 *European Law Review* 349, at 359.

[45] CJEU, Case C-168/95, *Arcaro*, [1996] ECR I-4730, para. 42; Case C-457/02, *Niselli*, [2004] ECR I-10853, para. 29; C-60/02, *X*, [2004] ECR I-651 para. 61; Joined Cases C-189/02 P, C-202/02 P, C-205/02 P to C-208/02 P and C-213/02 P, *Dansk Rørindustri and Others v Commission*, [2005] ECR I-5425, para. 221.

[46] CJEU, Case C-131/97, *Carbonari and Others*, [1999] ECR I-1103, para. 50; Joined Cases C-397/01 to C-403/01, *Pfeiffer and Others*, [2004] ECR I-8916, para. 115.

[47] Norbert Reich, 'The Interrelation between Rights and Duties in EU Law: Reflections on the State of Liability Law in the Multilevel Governance System of the Union: Is There a Need for a More Coherent Approach in European Private Law?' (2010) 29 *Yearbook of European Law* 112, at 158–159; Hans-Wolfgang Micklitz, 'The Paradox of Access to Financial Services for Consumers' (2010) 1 *Revue européenne de droit de la consommation/European Consumer Law Journal* 7, at 26; Gerald Spindler, 'Behavioural Finance and Investor Protection Regulations' (2011) 34 *Journal of Consumer Policy* 315, at 328; Martin Hobza, 'Investment Services and Protection of the Retail Client' (2015) 1 *The Lawyer Quarterly* 51, at 58.

on this issue. In Austria, some courts are reluctant to consider regulatory rules, and rather concern themselves with fundamental issues of contract law and consumer law.[48] The Dutch Supreme Court has argued that some regulatory rules 'influence' private law duties, but do not 'determine'.[49] Italian and Spanish courts establish particular mechanisms to alleviate the burden of proof in liability claims and even waive the need to prove the amount of damages, if an infringement of regulatory rules is proven.[50] The German Civil Law Supreme Court (*Bundesgerichtshof*) also gives its opinion of this issue: (i) since the court traditionally has assumed an implied agency contract between investment firms and their clients, relative contents of regulatory rules (such as the suitability and appropriateness requirements) are seen as contractual standards; but (ii) the court has not assumed that organisational duties, namely the internal control and conflict-of-interest requirements, are owed to the clients, nor does the court assume this for documentation duties.[51] In Greece, the prevailing opinion is that regulatory rules affect private law relation 'reflexively', through the general principles of private law (i.e., contract rules, consumer protection rules and tort provisions).[52] More different applications and implementations of MiFID's rule in private law cases can be found on asset managers' civil liabilities in different national courts.[53]

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[48] Susanne Kalss, 'Civil Law Protection of Investors in Austria – A Situation Report from Amidst a Wave of Investor Lawsuits' (2012) 13 *European Business Organization Law Review* 211, at 215.

[49] Olha O. Cherednychenko, 'European Securities Regulation, Private Law and the Investment Firm-Client Relationship' (2009) 5 *European Review of Private Law* 925, at 941–942.

[50] Federico Della Negra, 'The Private Enforcement of the MiFID Conduct of Business Rules. An Overview of the Italian and Spanish Experiences' (2014) 10 *European Review of Contract Law* 571, at 579–586.

[51] Stefan Grundmann and Christian Hofmann, 'EC Financial Services and Contract Law – Developments 2007–2010' (2010) 6 *European Review of Contract Law* 467, at 482–483.

[52] Vassilios Tountopoulos, 'Investor Protection under MiFID: A Survey of Greek Case Law' (2016) 27 *European Business Law Review* 513, 517–531.

[53] Danny Busch, 'Why MiFID Matters to Private Law—the Example of MiFID's Impact on An Asset Manager's Civil Liability' (2012) 7 *Capital Markets Law Journal* 386, at 386–413. For a comprehensive

3.2. *Bankinter* and *Banif Plus Bank* Cases

Given the chaos of MiFID's influence on private law systems, the Spanish court asked for clarification from the CJEU in the *Genil 48 and Comercial Hostelera de Grandes Vinos* case ('*Bankinter* case') on the basis of Article 267 of the TFEU.[54] In this case from Spain, as MiFID's 'suitability'[55] and 'appropriateness'[56] requirements are transposed into administrative rules only in Spanish law, a relevant question arose: whether an interest-rate swap agreement to cover the risk of variations of interest rates would be 'void *ab initio*' if the 'suitability' and 'appropriateness' tests under MiFID are not meet?[57] The CJEU confirmed that the MiFID regime, albeit it rules the imposition of administrative measures or sanctions against infringements, does not state either Member States must provide for 'contractual consequences' in the event of contracts being concluded which do not comply with the obligations under national legal provisions transposing MiFID's investment conduct rules, or what those consequences might be.[58] In the absence of any clear provision, for the internal legal order of each Member State, Member States could determine 'contractual consequences' where an investment firm offering investment services fails to comply with these requirements, subject to observance of the principles of equivalence and effectiveness.[59] The answer to this case is examined again by the CJEU in the *Banif Plus Bank Zrt. v Márton Lantos,*

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analysis of private-law divergences in Member States regarding the liability of asset managers: see Danny Busch and Deborah A. DeMott (eds), *Liability of Asset Managers* (Oxford University Press 2012), Parts III–V.

54 CJEU, Case C-604/11, *Genil 48 SL and Comercial Hostelera de Grandes Vinos SL v Bankinter SA and Banco Bilbao Vizcaya Argentaria SA*, [2013] EU:C:2013:344.

55 Article 19.4 of MiFID I; see further in Section 3.3.6 of CHAPTER II (pp. 48–50).

56 Article 19.5 of MiFID I; see further in Section 3.3.6 of CHAPTER II (pp. 50–51).

57 CJEU, Case C-604/11, above note 54, para. 22.

58 Ibid, para. 57.

59 Ibid, para. 58.

Mártonné Lantos case (*Banif Plus Bank* case).[60] In this case, the CJEU confirmed that national courts could rule on the classification of the terms within a foreign currency denominated consumer credit agreement once they could follow the standard established by the *Bankinter* case.[61] However, according to the CJEU's opinion given by these two cases, there are two possibly extended and polarised arguments. On the one hand, some may argue these two case laws can be interpreted as: (i) characterising MiFID I's duties as contractual or other private law rules that 'gives individual claims' to clients, and (ii) leaving 'the freedom to national law to determine the private law remedies'.[62] This understanding imposes on Member States an 'obligation' to transpose MiFID's rules into their private law systems, albeit they enjoy the freedom of how to do so. On the other hand, it is also possible to treat the CJEU's opinion in these two cases as a clear emphasis on the administrative nature of MiFID's rules.[63] In this reading, the CJEU just repeats a 'right' of Member States to transpose MiFID's rules into their private laws within its well-established case law, and the only condition of this transposition is to follow the principles of equivalence and effectiveness. Therefore, it is still unclear whether these two case laws impose Member States an 'obligation' to transpose MiFID's investment conduct rules into their private laws.

By considering the wording of the MiFID regime and its legislative history, the latter reading above might be more convincing here than the first reading. There are two

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[60] CJEU, Case C-312/14, *Banif Plus Bank Zrt. v Márton Lantos, Mártonné Lantos*, [2015] ECLI:EU:C:2015:794.
[61] Ibid, para. 79.
[62] Stefan Grundmann, 'The Bankinter Case on MIFID Regulation and Contract Law' (2013) 9 *European Review of Contract Law* 267, at 278; F. D. Negra, above note 50, at 578–579.
[63] Olha O. Cherednychenko, 'Public and Private Enforcement of European Private Law in the Financial Services Sector' (2015) 24 *European Review of Private Law* 621, at 635–636.

reasons for this. First, if the EU law wants to impose such an obligation on Member States, it must be written in provisions unequivocally. For example, in Article 6.2 of the Prospective Directive,[64] it clearly states that 'Member States shall ensure that their laws, regulation and administrative provisions on civil liability apply to those persons responsible for the information given in a prospectus.' Also, Article 11.1 of the KID Regulation[65] explicitly requires that 'the PRIIP manufacturer shall not incur civil liability solely on the basis of the key information document, including any translation thereof, unless it is misleading, inaccurate or inconsistent with the relevant parts of legally binding pre-contractual and contractual documents or with the requirements laid down in Article 8.' In contrast, Article 69 of MiFID II (which is entitled 'supervisory powers') only mentions 'Member States shall ensure that mechanisms are in place to ensure that compensation may be paid or other remedial action be taken in accordance with national law for any financial loss or damage suffered as a result of an infringement of this Directive [MiFID II] or of Regulation (EU) No 600/2014 [MiFIR]'. Recital 7 of MiFID II also expressly states: '[t]he form of a Directive is appropriate in order to enable the implementing provisions in the areas covered by this Directive, when necessary, to be adjusted to any existing specificities of the particular market and legal system in each Member State.' Since the mechanisms might be formed by either administrative measures or civil liabilities, there is no place to restrict the Treaty 'right' of Member States by turning it into an 'obligation'.[66] There is no clear provision to

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[64] Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, 2003 OJ L345/31.

[65] Regulation (EU) No 1286/2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), 2014 OJ L352/2.

[66] For a similar argument relating to the Market Abuse Directive: see Vassilios Tountopoulos, 'Market

impose Member States an 'obligation' to transpose MiFID's investment conduct rules into their private laws.

Second, there have been many efforts to try to harmonise the civil liability of MiFID's investment conduct rules, but these have failed. For example, the Commission was aware of this issue since the drafting of MiFID I,[67] and the Parliament also attempted to make clear that MiFID I supersedes traditional pre-existing civil liabilities.[68] But, all of these voices disappeared in the final context of MiFID I. During the period of consultation on MiFID II, the Commission again proposed to build a principle of civil liabilities with regard to relevant obligations of investment conduct,[69] but MiFID II did not address this issue eventually. These precedents not only prove the Treaty difficulties of introducing harmonised rules in private law, but also indicate that, compared to private law, a consensus on harmonising administrative legislation is much easier to be reached among European policymakers.[70]

Indeed, in order to build up a common capital market law in the EU, some may

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Abuse and Private Enforcement' (2014) 11 *European Company & Financial Law Review* 297, at 302–304.

[67] 'Consequently, retail investors may derive benefit and confidence from the possibility of seeking redress within their own jurisdiction': see Commission of the European Communities, Communication from the Commission to the European Parliament and the Council: Upgrading the Investment Services Directive (93/22/EEC), COM (2000) 729 Final, November, 2000, at 10, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52000DC0729&from=EN> (accessed June, 2017).

[68] European Parliament, Report on the proposal for a European Parliament and Council directive on Investment services and regulated market, and amending Council Directives 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council 2000/12/EC (COM(2002) 625 – C5-0586/2002 – 2002/0269(COD)), A5-0287/2003, September, 2013, Amendment 23, available at: <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A5-2003-0287+0+DOC+PDF+V0//EN> (accessed June, 2017).

[69] European Commission, Public Consultation: Review of the Markets in Financial Instruments Directive (MiFID), December, 2010, para. 7.2.6, available at: <http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf> (accessed June, 2017).

[70] Takis Tridimas, 'EU Financial Regulation: Federalization, Crisis Management, and Law Reform' in Paul Craig and Gráinne de Búrca (eds), *The Evolution of EU Law* (Oxford University Press, 2011), at 793–794.

keep arguing for a necessary harmonisation of MiFID's civil liabilities by further legislation.[71] However, the Treaty limitations may not easily allow the EU to do so.[72] The CJEU is unable to create an obligation on Member States to transpose MiFID's rules into their private laws. As a sign of the CJEU's disability of adopting a uniform approach towards this sensitive issue, Member States should retain the freedom to transpose MiFID's rules, whether into their administrative rules or private law. This would leave different models reflecting elements of the current practices in a variety of jurisdictions.[73]

3.3. Irreplaceable but Divergent Practices of National Private Law

In fact, whether there is an obligation on Member States to transpose MiFID's rules into their national private law systems, the important role of national private law could never be replaced. For example, even if MiFID's rules are transposed into Member States' national private law systems,[74] civil liability of these rules are still relied on domestic private law and courts in order to maintain the internal order of each Member State, because there is no harmonised rule regarding the MiFID's civil liability. Furthermore, even if MiFID's rules are transposed into Member States' regulatory rules only, MiFID's horizontal indirect effect and these regulatory rules' influence on private law cases,[75] both depends largely on the application of national private law by national

[71] Thomas M. J. Möllers, 'European Legislative Practice 2.0: Dynamic Harmonisation of Capital Markets Law - MiFID II and PRIIP' (2015) 31 *Banking & Finance Law Review* 141, at 168 and 170–171.
[72] See Section 2.2 above (pp. 197–199).
[73] Cherednychenko further classified four possible models of the relationship between MiFID's rules and national private law system: (i) substitution, (ii) separation, (iii) complementarity and (iv) integration. See Olha O. Cherednychenko, 'Contract Governance in the EU: Conceptualising the Relationship between Investor Protection Regulation and Private Law' (2015) 21 *European Law Journal* 500, at 504–518.
[74] See further in Section 3.1 above (pp. 200–201).
[75] See further in Section 3.1 above (pp. 201–203).

courts. Also, if there is an issue not covered by MiFID's rules or national regulatory rules, national private law has the potential to address problems encountered by individual investors in relation to investment firms.[76] For example, a large number of decisions that relied on various private law techniques were made by English courts to address unregulated problems of the over-the-counter ('OTC') markets during the financial crisis.[77] In any case, national private law systems underpin the well-functioning of European capital markets law.[78] By taking into account of this role of national private law systems, national courts might be considered as another type of authorities in governing investment conduct,[79] as 'quasi-agencies' (quasi-regulators).[80]

Without doubt, these quasi-agencies/national courts would recognise the supremacy of a European measure in accordance with the established constitutional structure.[81] Nevertheless, the CJEU, unlike ESMA, only has power to co-ordinate national private law systems in accordance with Article 267 of the TFEU. As clarified by the *Freiburger Kommunalbauten* case, the CJEU is not a court of last instance to rule on the application of a particular term that must be considered in the light of the particular

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[76] O. O. Cherednychenko, 'European Securities Regulation, Private Law and the Investment Firm-Client Relationship', above note 49, at 945.

[77] See, e.g., *Pioneer Freight Futures Co Ltd (in liquidation) v TMT Asia Ltd* [2011] EWHC 778 (Comm); [2011] 2 Lloyd's Rep. 96; *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm). For comprehensive statistical data: see Joanne P. Braithwaite, 'OTC Derivatives, the Courts and Regulatory Reform' (2012) 7 *Capital Markets Law Journal* 364, at 365–371.

[78] Rüdiger Veil, 'Enforcement of Capital Markets Law in Europe - Observations from a Civil Law Country' (2010) 11 *European Business Organization Law Review* 409, at 421; Athanasios G. Panagopoulos, Thomas Chatzigagios and Ioannis Dokas, 'The Main Effects of MiFID on European Capital Markets and European Integration' (2015) 6 *International Journal of Business Administration* 52, at 58.

[79] Steve Hedley, 'Courts as Public Authorities, Private Law as Instrument of Government' in Kit Barker and Darryn Jensen (eds), *Private Law: Key Encounters with Public Law* (Cambridge University Press, 2013), at 89–90.

[80] Hans-W. Micklitz, 'The Transformation of Enforcement in European Private Law: Preliminary Considerations' (2015) 23 *European Review of Private Law* 491, at 509.

[81] See, e.g., CJEU, Case 26/62, *NV Algemene Transporten Expeditie Onderneming van Gend & Loos v Netherlands Inland Revenue Administration*, [1963] ECR 1, at 12; Case 106/77, *Amministrazione delle Finanze dello Stato v Simmenthal SpA*, [1978] ECR 629, para. 22.

circumstances of the case in question by national courts, so the CJEU has only a very limited opportunity to interpret the general criteria of relevant EU provisions.[82] On the one hand, each Member State's court systems could easily develop their own interpretation and understanding of the EU's law of governance in the absence of a hierarchical judicial system (such as, the federal court in the USA).[83] On the other hand, national courts need this flexibility of interpretation in each case. This is because judges in private law systems cannot withdraw from their offices when new cases occur.[84] National courts have to fill the 'regulatory voids' of the EU legislation by relevant civil law principles.[85]

This decentralised model inevitably and necessarily would cause different interpretations and applications of European private law. For example, a British court can interpret the meaning of 'good faith' in Article 3 of Council Directive 93/13/EEC on Unfair Terms in Consumer Contracts ('UCTD')[86] within the traditional common law notions, and it is unnecessary either to refer the matter to the CJEU or to consider other potential meanings in continental system.[87] In contrast, Germany has developed

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82 CJEU, Case C-237/02, *Freiburger Kommunalbauten GmbH Baugesellschaft & Co. KG v Ludger Hofstetter and Ulrike Hofstetter*, [2004] ECR I-3403, para. 22. For critiques of this restrictive explanation of the CJEU's role: see Peter Rott, 'What is the Role of the ECJ in EC Private Law?' (2005) 1 *Hanse Law Review* 6, at 9–17; Christoph U. Schmid, 'Judicial governance in the European Union: The ECJ as a constitutional and a private law court' in Erik Oddvar Eriksen, Christian Joerges and Florian Rödl (eds), *Law, Democracy and Solidarity in a Post-national Union: The Unsettled Political Order of Europe* (Routledge, 2008), at 92.

83 Hugh Collins, 'Governance Implications for the European Union of the Changing Character of Private Law' in Fabrizio Cafaggi and Horatia Muir Watt (eds), *Making European Private Law: Governance Design* (Edward Elgar Publishing, 2010), at 271–272.

84 Jürgen Basedow, 'Codification of Private Law in the European Union: the Making of a Hybrid' (2001) 9 *European Review of Private Law* 35, at 42–43.

85 Heikki Marjosola, 'What Role for Courts in Protecting Investors in Europe – A View from Finland' (2014) 10 *European Review of Contract Law* 545, at 562.

86 Council Directive 93/13/EEC on unfair terms in consumer contracts, 1993 OJ L95/29. ('UCTD')

87 *Director General of Fair Trading v First National Bank Plc* [2001] UKHL 52; [2002] 1 A.C. 481, para. 25.

Treu und Glauben which is different to the British concept of good faith.[88] Similar situations could possibly happen in the explanation of terms of 'honestly', 'fairly' and so on in many MiFID's rules. In this sense, the effort of harmonisation of the legal order in the EU is an 'irritant' of new divergences because of different legal cultures in Member States (such as, different traditions, structures and understandings of values).[89] Indeterminacy and unforeseeability will always happen at the national level after the introduction of EU law—the so-called 'Jack-in-the-Box effects'[90]— Member States will always use the most appropriate way to transpose, apply and explain these EU rules.

3.4. Is EJN-Civil Enough?

Given the aforementioned divergences of private law systems between Member States (particularly between the civil law and common law systems), a European Judicial Network in civil and commercial matters ('EJN-civil') was established in 2001[91] and later enhanced in 2009.[92] By means of establishing a network at the EU level to facilitate co-operation[93] and integrate the legal professions in different Member States,[94] it improves effective judicial co-operation between Member States and effective access

88 Gunther Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergencies' (1998) 61 *Modern Law Review* 11, at 18–22.
89 Ibid, at 11–17. For a similar phenomenon in European consumer law: see Christian Twigg-Flesner, 'Time to Do the Job Properly-The Case for a New Approach to EU Consumer Legislation' (2010) 33 *Journal of Consumer Policy* 355, at 357–359.
90 Thomas Wilhelmsson, 'Jack-in-the-Box Theory of European Community Law' in Ludwig Krämer, Hans-W. Micklitz and Klaus Tonner Nomos (eds), *Law and Diffuse Interests in the European Legal Order* (Nomos, 1997), at 188–191; Thomas Wilhelmsson, 'Private Law in the EU: Harmonised or Fragmented Europeanisation?' (2002) 10 *European Review of Private Law* 77, at 79–82.
91 Council Decision 2001/470/EC establishing a European Judicial Network in civil and commercial matters, 2001 OJ L174/25 ('EJN-civil Decision'). The UK opted into this network: see Recital 18 of EJN-civil Decision.
92 Decision No 568/2009/EC of The European Parliament and of The Council amending Council Decision 2001/470/EC establishing a European Judicial Network in civil and commercial matters, 2009 OJ L168/35. ('New EJN-civil Decision') The UK also opted in this new decision: see Recital 20 of New EJN-civil Decision.
93 Recital 10 of EJN-civil Decision.
94 Recital 5 of New EJN-civil Decision.

to justice for people engaging in cross-border litigation.[95] It should be noted that the function of the EJN-civil focuses on information exchange,[96] so it has no binding power in relation to national courts. This network, at most, plays a supporting role in European private law. This again shows the Treaty limitations on harmonisation of European private law.[97] In the field of the private law governance of investment conduct, the EU can only have little competence.

On the whole, in view of the lack of ability to the private law's governance role in the EU, it is not entirely clear to what extent investors will really benefit from the private enforcement of MiFID's investment conduct rules, and to what extent MiFID's rules will be able to ensure a high level of investor protection in private cases currently.[98] Is the EJC-civil enough to tackle the cross-border private law issues of MiFID regime in the EU? In order to clarify this, the interaction between MiFID's rules and the UK's private law is going to be examined in the next section.

4. MiFID and National Private Law: UK's Practice

4.1. MiFID and UK's National Private Law

In order to examine MiFID's influence on national private law systems in practice, the following section will explore the implementation of MiFID's rules in private law cases in the UK.[99] This is because the UK's legal system includes all possibilities to

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[95] Recital 9 of EJN-civil Decision and Recitals 14 of New EJN-civil Decision.
[96] Article 3.1 of EJN-civil Decision.
[97] See Section 2.2 above (pp. 197–199).
[98] Olha O. Cherednychenko, 'The Legal Matrix for Retail Investment Services in the EU: Where is An Individual Investor?' in James Devenney and Mel Kenny (eds), *Consumer Credit, Debt and Investment in Europe* (Cambridge University Press, 2012), at 277.
[99] Since there are different legal systems in England and Wales, in Scotland and in Northern Ireland

realise MiFID's private law influence: first, the Financial Services and Markets Act 2000 ('FSMA') provides a civilly actionable right to claim remedies from infringements of FCA's rules;[100] second, the UK's case law system, by means of horizontal indirect effect, provides a possibility for *de facto* horizontal direct effect of MiFID's rules;[101] and, third, MiFID's rules are totally transposed into FCA Handbook as regulatory rules.[102] It should be noted again that, although the UK triggered the official Brexit process on 29th March, 2017,[103] and this eventually will change the relationship between the UK law and the EU law, the analysis below is still based on the current status given the fact that this change may not happen before 2019 and the FCA is going to implement MiFID II in the UK.[104]

4.1.1. Financial Services and Markets Act 2000

A statute in the UK may provide a right of action caused by a breach of the

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respectively, this section will mainly focus on the cases in England if there is no specific emphasis.

100 Section 138D of FSMA. See further in Section 4.1.1 below (pp. 213–216).

101 See further in Section 4.1.2 below (pp. 216–218).

102 See further in Section 4.1.3 below (pp. 219–221). According to FSA's Consultation Paper, the MiFID legislation is incorporated by 'intelligent copy-out' of the text (that is, our rules will generally be based on copied-out directive text to avoid placing any unintended additional obligations on firms): see FSA, *Reforming Conduct of Business Regulation* (Consultation Paper CP06/19, 2006), para. 2.11, available at: <http://www.fsa.gov.uk/pubs/cp/cp06_19.pdf> (accessed June, 2017).

For a comprehensive discussion about the introduction of MiFID's rules into the FCA Handbook: see Paul Nelson, *Capital Markets Law and Compliance: The Implications of MiFID* (Cambridge University Press, 2008), Part IV.

103 A letter from the British Prime Minister, Theresa May, notifying the United Kingdom's intention to leave the European Union (29th of March, 2017), available at: <http://www.consilium.europa.eu/en/press/press-releases/2017/03/pdf/070329_UK_letter_Tusk_Art50_pdf/> (accessed June, 2017).

104 FCA, Statement on European Union referendum result, 24 June 2016, available at: <https://www.fca.org.uk/news/statements/statement-european-union-referendum-result> (accessed June, 2017).

On 30 March, 2017, the UK Government promised to transpose the EU law into national/domestic law after the official Brexit process for maintaining the legal certainty. See further in UK Government, Legislating for the United Kingdom's withdrawal from the European Union, March, 2017, available at: <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/604516/Great_repeal_bill_white_paper_accessible.pdf> (accessed June, 2017). ('The Great Repeal Bill: White Paper')

statutory duty for injury thereby imposed, which is not relegated to other civil remedies,[105] or the provisions for the administrative imposition.[106] Such liability can be based on a 'breach of statutory duty simpliciter',[107] provided that the provisions and structure of the statute intend to create a statutory right which is distinct from common law duties.[108] Given this, Section 138D (formerly Section 150 as originally enacted) of FSMA states that 'a contravention by an authorised person of a rule made by the FCA is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.' FCA's Conduct of Business Sourcebook ('COBS') Sch 5.4G further explains the application of this statutory claim in detail.[109] Thanks to the legal basis of FSMA, civilly actionable claims for breaches of such regulatory rules transposed from the MiFID regime are grounded in the UK's legal system. This statutory claim often results in a more easily established liability,[110] so it is now routinely pleaded along with the usual common law claims by 'private persons'.[111] However, it should be noted that MiFID's investment conduct rules, in the UK, are transposed into FCA's COBS rather than FSMA, so, precisely, this civilly actionable statutory claim for breaches of COBS is not a main product, but a by-product of transposition of MiFID's rules. As Lord Hodge

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105 *Groves v Lord Wimborne* [1898] 2 Q.B. 402, at 416–417.
106 Ibid, at 409.
107 *X (Minors) v Bedfordshire CC* [1995] 2 A.C. 633, at 730.
108 *Gorringe v Calderdale MBC* [2004] UKHL 15; [2004] 1 W.L.R. 1057, para. 3.
109 In COBS Sch 5.4G, it differentiates COBS rules: some may not be actionable for 'private persons'.
110 Roger Stewart and John L. Powell, *Jackson & Powell on Professional Liability* (7th edn, Sweet & Maxwell, 2012), para. 14-072.
111 See, e.g., *Redmayne Bentley Stockbrokers v Isaacs* [2010] EWHC 1504 (Comm), (breach of contract, duty of care and formerly FSMA ss. 71 & 150); *Wilson v MF Global UK Ltd* [2011] EWHC 138 (QB), (breach of contract and formerly FSMA s. 150); *Bank Leumi (UK) plc v Wachner* [2011] EWHC 656 (Comm); [2011] 1 C.L.C. 454, (misrepresentation, duty of care and formerly FSMA s. 150); *John Green and Paul Rowley v The Royal Bank of Scotland plc* [2013] EWCA Civ 1197; [2014] Bus. L.R. 168, (duty of care and formerly FSMA s. 150).

clarified in *Grant Estates Ltd v Royal Bank of Scotland Plc* (a Scottish case):

> 'MiFID does not require a member state to provide protection to a customer by means of a direct right of action against the authorised person. Nor did the United Kingdom choose to confer such a right when it implemented MiFID […]. [Section 138D of FSMA] were a response to a perceived mischief which antedated MiFID.'[112]

Furthermore, this statutory right is extremely limited as it has many preliminary conditions. First, a 'private person' is defined in a restrictive way: the claimant, generally, must be an individual, and corporate persons may use this provision only if they were not 'conducting business of any kind'.[113] The definition of 'conducting business', which is given by *Titan Steel Wheels Ltd v Royal Bank of Scotland plc*,[114] further limits the possibility of corporate persons to apply this statutory claim. Second, the FCA must not have removed the availability of a right of action for the rule in question.[115] It is noteworthy that three important rules of FCA Handbook are excluded: (i) the PRIN rules, in particular PRIN 2.1.1R with respect to fiduciary principles of business;[116] (ii) SYSC 10, in terms of senior management arrangements, systems and controls regarding

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112 *Grant Estates Ltd v Royal Bank of Scotland Plc* [2012] CSOH 133; 2012 G.W.D. 29-588, para. 48.

113 Article 3 of Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001, SI 2001/2256. It should be noted here that the regulatory definition of 'retail client' and 'private person' are not co-extensive. For the definition of 'retail client': see Section 3.3.1 of CHAPTER II (p. 35).

114 [2010] EWHC 211 (Comm); [2010] 2 Lloyd's Rep. 92, para. 65: 'there are three types of trade carried out by a business which may be in the course of that business: i) A one-off trade with a view to profit. Such a case, regardless of how sporadic, would be in the course of the business. ii) A sporadic series of trades which were not part of the normal practice of the business nor an integral part of the business. This would not be "in the course of the business". iii) A regular trade which was part of the normal practice of the business in question.' See also *Camerata Property Inc v Credit Suisse Securities (Europe) Ltd* [2012] EWHC 7 (Comm); [2012] 1 C.L.C. 234, paras. 94–98.

115 Section 138D(3) FSMA.

116 FCA Handbook, PRIN 3.4.4R.

conflicts of interest;[117] and (iii) the 'fair, clear and not misleading' rule, under COBS 4.2.1R if, in relation to a particular communication or financial promotion, a firm takes reasonable steps to ensure it complies with the 'fair, clear and not misleading' rule.[118] Third, the claimant is still required to show not only a breach of relevant rules, but also many elements, such as, a causal nexus between the breach and the loss.[119] But, the approach in contract and/or tort to causation, foreseeability and remoteness here will be 'guided by the focus and purpose of the statutory provisions',[120] which means they may operate in different ways in such statutory claims.[121] Finally, the defendant of this statutory claim is limited to the 'authorised person', as defined by Section 138D of FSMA. To those unauthorised people, they are not eligible to be claimed by this article, but they might be governed by other common law duties instead.[122] On the whole, this statutory claim, based on FSMA and FCA Handbook, is significantly different and independent from other claims in private cases, but its function still largely depends on explanations of courts in private law cases.

4.1.2. MiFID's Horizontal Indirect Effect in Private Cases

In terms of the horizontal effect of MiFID's rules, two relevant cases deserves to be mentioned. In *Nextia Properties Ltd v Royal Bank of Scotland*,[123] the claimant, which is a company in the property development business, entered into an interest rate swap

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117 FCA Handbook, SYSC 1 Annex 1.2.19R.
118 FCA Handbook, COBS 4.2.6R.
119 Iain G. MacNeil, 'FSA 1986: Does S.62 Provide An Effective Remedy for Breaches of Conduct of Business Rules?' (1994) 15 *Company Lawyer* 172, at 175–176.
120 *Rubenstein v HSBC Bank plc* [2012] EWCA Civ 1184; [2013] 1 All E.R. (Comm) 915, para. 46.
121 Ibid, para. 45.
122 Robert H. Sitkoff, 'The Fiduciary Obligations of Financial Advisers under the Law of Agency' (2014) 27 *Journal of Financial Planning* 42, at 45–48. See further in Section 4.2 below (pp. 221–239).
123 *Nextia Properties Ltd v Royal Bank of Scotland* [2013] EWHC 3167 (QB).

agreement with the defendants. The claimant originally contended that the defendants breached the duties of fair and accurate communication, costs disclosure and conflicts of interest disclosure in FCA Handbook and MiFID's rules simultaneously, followed by a claim of damage for breaches of statutory duties, but, the claimant later accepted that neither MiFID, nor its implementing Directives, give rise to a direct right of action, so it was only necessary to consider whether English domestic law, namely the FSMA and FCA Handbook in this case, gave a right of action.[124] The same, in *Grant Estates Ltd v Royal Bank of Scotland Plc* (a Scottish case with similar facts as the above *Nextia* case),[125] the pursuer also accepted there was no direct claim that could be made against the defenders under MiFID, so the real issue is the correct interpretation of the UK legislation and regulatory rules having regard to the results which MiFID sought to achieve.[126] In these cases, although the courts did not reject the horizontal direct effect of MiFID explicitly, the courts correctly followed the consistent EU case law implicitly. That is, a Directive, like MiFID here, could have horizontal indirect effect on the client/investment firm relationships at the most.[127]

As to the horizontal indirect effect of MiFID's rules, the decision of the Supreme Court in the well-known case of *Re Lehman Brothers International (Europe)*,[128] provides a clear indication. This case related to a 'statutory trust' in the FCA's Client Assets Sourcebook ('CASS').[129] According to CASS 7.7.2R, a firm receives and holds client

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124 Ibid, para. 100.
125 *Grant Estates Ltd v Royal Bank of Scotland Plc* [2012] CSOH 133; 2012 G.W.D. 29-588.
126 Ibid, para. 32.
127 See further in Section 3.1 above (pp. 201–202).
128 *CRC Credit Fund Ltd v GLG Investments Plc Sub-Fund: European Equity Fund Lehman Brothers International (Europe) (In Administration) v CRC Credit Fund Ltd* [2012] UKSC 6; [2012] 3 All E.R. 1.
129 Although it is not the focus of this study, for a comprehensive analysis of this case: see Panagiotis K.

money as trustee: (i) for the purposes of the client money rules and the client money (MiFID business) distribution rules, and (ii) for the clients for whom that money is held according to their respective interests in it, with certain immaterial exceptions. However, the issues of this regulatory rule are: 'when does the statutory trust arise? Does it arise only when the money has been placed in a segregated client account, or is the money subject to the trust as soon as it is in the firm's hands irrespective of where it puts the money?'[130] In order to answer these questions, Lord Dyson incorporated MiFID I (and its implementing Directive) in his explanation: he first confirmed that the purpose of the MiFID regime includes providing a high level of protection for clients and safeguarding their rights to funds in the event of the insolvency,[131] and then agreed that a trust of client money received by a firm arises upon receipt, rather than only upon segregation by reference to the purpose of MiFID's regime.[132] Although this case is not directly relevant to the COBS or MiFID's investment conduct rules, the court directly applied MiFID's rules in explaining (or even *de facto* creating) a trust relationship between clients and investment firms. This can strongly prove a possibility for MiFID's investment conduct rules to influence private law by the horizontal indirect effect. Having said that, as Lord Dyson highlighted, the horizontal indirect effect of MiFID still has to follow some principles:

'(i) it is not constrained by conventional rules of construction; (ii) it does not

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Staikouras, 'A Novel Reasoning of the UK Supreme Court decision in Lehman Brothers: The MiFID Segregation Rule from the Angle of Financial Intermediation and Regulation Theory' (2014) *Journal of Business Law* 97, at 97–120.

130 Ibid, para. 4.

131 Ibid, paras. 132–134.

132 Ibid, para. 135.

require ambiguity in the legislative language; (iii) it is not an exercise in semantics or linguistics; (iv) it permits departure from the strict and literal application of the words which the legislature has elected to use; (v) it permits the implication of words necessary to comply with Community law; and (vi) the precise form of the words to be implied does not matter.'[133]

4.1.3. FCA's COBS Handbook in Private Cases

Given that MiFID's investment conduct rules are transposed into the FCA's COBS entirely, the next question is the impact of such regulatory rules in private law cases. This question should be answered by reference to the influence of FCA's rules on contracts and on other common law duties respectively. First, in some cases, courts might be inclined to give these rules the status of contract terms, so contravention of these rules becomes actionable at common law as a breach of contract. For example, in *Larussa-Chigi v CS First Boston Ltd*, Thomas J. suggested that the Bank of England's London Code of Conduct, even if the parties had not expressly incorporated the Code, have been incorporated as a matter of contract, comprising an implied term, because there is a clause mentioning that 'the transactions will be governed by a Code of Conduct established by the Bank of England'.[134] But, most cases reject this approach,[135] which means the FCA's rules cannot become implied contractual terms. However, this is not to deny the influence of the FCA's rules on contracts. Specifically, the FCA

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[133] Ibid, para. 131.

[134] [1998] C.L.C. 277, at 293–295; see also *Investors Compensation Scheme Ltd v West Bromwich Building Society (No.2)* [1999] Lloyd's Rep. P.N. 496, at 504.

[135] See, e.g., *Redmayne Bentley Stockbrokers v Isaacs* [2010] EWHC 1504 (Comm), para. 94; *Wilson v MF Global UK Ltd* [2011] EWHC 138 (QB), para. 14; *Shelley Barnes, Darren Barnes v Black Horse Limited* [2011] EWHC 1416 (QB); [2011] 2 All E.R. (Comm) 1130, para. 38; *Clarion Limited and Others v National Provident Institution* [2000] 1 W.L.R. 1888, at 1894–1898.

Handbook states that the duties imposed by regulatory rules may not be contractually overridden: 'a firm must not, in any communication relating to designated investment business seek to: (i) exclude or restrict; or (ii) rely on any exclusion or restriction of; any duty or liability it may have to a client under the regulatory system.'[136] It also requires that any duty or liability of an investment firm to a retail client, other than under the regulatory system, shall not be excluded or restricted in any communication, in order to comply with the client's best interests rule.[137] Through these provisions, FCA's rules may affect contractual terms in the practice of financial markets. However, whilst the FCA's rules announce that the obligation to act in the 'best interest of clients' may not be contractually overridden, courts have consistently held that such contractual clauses shall still be valid: this is not for unduly restricting or excluding liabilities, but for interpreting the parties' duties to each other in line with the contractual terms.[138]

Second, although some may argue that these regulatory rules could be seen as a legitimate expectation creating a fiduciary duty for investors,[139] a clear point made by the Court of Appeal in *Gorham v British Telecommunications* is that common law duties and regulatory rules are not co-extensive.[140] Lord Hodge in *Grant Estates Ltd v Royal Bank of Scotland Plc* (a Scottish case) also adopts an approach based on a clear separation

136 FCA Handbook, COBS 2.1.2R.

137 FCA Handbook, COBS 2.1.3 G (1).

138 See, e.g., *IFE Fund v Goldman Sachs International* [2006] EWHC 2887 (Comm); [2007] 1 Lloyd's Rep. 264, para. 71 (affirmed by the Court of Appeal: see *IFE Fund v Goldman Sachs International* [2007] EWCA Civ 811; [2007] 2 Lloyd's Rep. 449); *Springwell Navigation Corp v JP Morgan Chase Bank (formerly Chase Manhattan Bank)* [2010] EWCA Civ 1221; [2010] 2 C.L.C. 705, para. 184.

139 Christa Band and Karen Anderson, 'Selling Complex Financial Products to Sophisticated Clients: JP Morgan Chase v Springwell: Part 2' (2009) 24 *Journal of International Banking Law and Regulation* 233, 242–243; Adrian Fong, 'Fiduciary Duty in the Context of Providing Investment Services' (2013) *Journal of International Banking Law and Regulation* 390, at 391–393.

140 *Gorham & Others v British Telecommunications Limited plc, The Trustees of the BT Pension Scheme, Standard Life Assurance Company* [2000] 1 W.L.R. 2129, at 2141.

between the domains of regulatory rules and common law duties and remedies:

> 'a common law duty can arise from the existence of a statutory duty as part of the background circumstances; and the existence of a statutory duty may show that a particular risk should have been foreseen. […] Looking to the policy of the FSMA one discovers that it provides protection to consumers of financial services through a self-contained regulatory code and statutory remedies for breach of its rules.'[141]

'[T]he mere existence of a regulatory duty of itself […] [does not bring] about the creation of a co-extensive common law duty'.[142] However, it is admitted that FCA's rules afford 'strong evidence' as to what is expected of a competent adviser in most situations.[143] It is useful to start with the requirements of relevant regulatory regimes in determining the extent of a common law duty to act with the skill and care to be expected of a reasonably competent financial advisor,[144] in particular the duty of care ordinarily includes compliance with the relevant regulatory rules.[145] By means of this, abuses of common law duties in circumstances in which there would be no regulatory cause of action could be firmly prevented.[146] Thus, in the UK's practice, the determination of common law duties is influenced by FCA's rules to some extent.

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141 *Grant Estates Ltd v Royal Bank of Scotland Plc* [2012] CSOH 133; 2012 G.W.D. 29-588, para. 79.

142 *John Green and Paul Rowley v The Royal Bank of Scotland plc* [2013] EWCA Civ 1197; [2014] Bus. L.R. 168, para. 29.

143 *Seymour v Ockwell* [2005] EWHC 1137 (QB); [2005] P.N.L.R. 39, para. 77.

144 *Shore v Sedgwick Financial Services Ltd* [2007] EWHC 2509 (Admin); [2008] P.N.L.R. 10, para. 161 (affirmed by the Court of Appeal: see *Shore v Sedgwick Financial Services Ltd* [2008] EWCA Civ 863; [2009] Bus. L.R. 42).

145 *Loosemore v Financial Concepts* [2001] Lloyd's Rep. P.N. 235, at 241–242.

146 Lucy James and Lucy James, 'Green and Rowley v RBS - A Case for A Concurrent Duty of Care?' (2014) 29 *Journal of International Banking Law and Regulation* 110, at 113.

4.2. Long-Standing National Private Law

Given that MiFID's rules undoubtedly have some influence on national private law in the UK, a question arises: whether national private law is not important any longer? In fact, national courts, in practice, have regard to a range of sources in cases: they will start by looking at contractual documents, then FCA's rules and even MiFID's rules, followed by consideration of other judge-made law.[147] In most cases, contractual terms and the judge-made law are the key of judges to governing investment conduct and resolving disputes. The role of national private law, thus, is unshakable and irreplaceable whether before or after the introduction of MiFID's rules. As Professor Goode observed:

> '[…] most of our commercial law is judge-made; and what the judges have created they are free to change to reflect new social or economic considerations or to correct principles or rules that can now be seen to have been mistaken.'[148]

It is important to emphasise that 'the common law is not antipathetic to concurrent liability',[149] so, next to the aforementioned Section 138D of FSMA, there may be many different resources of judge-made law raising different types of remedies.[150] The claimant is just required to choose which alternative he/she wants at the time when judgment is awarded in his favour.[151]

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[147] See many cases exemplified in above note 111.
[148] Roy Goode, *Commercial Law in the Next Millennium* (Sweet & Maxwell, 1998), at 15.
[149] Browne-Wilkinson LJ.: 'My own belief is that, in the present context, the common law is not antipathetic to concurrent liability, and that there is no sound basis for a rule which automatically restricts the claimant to either a tortious or a contractual remedy.'*Henderson v Merrett Syndicates Ltd (No.1)* [1995] 2 A.C. 145, at 193–194.
[150] See further in R. Stewart and J. L. Powell, above note 110, Ch. 3.
[151] *Tang Man Sit (Deceased) v Capacious Investments Ltd* [1996] A.C. 514, at 525–526. See further in John

4.2.1. Contractual Terms

In spite of some rare cases, investment firms and their clients usually have written contracts in normal cases, so courts treat the contracts as the starting point and interpret the parties' duties in line with the contractual terms.[152] The scope of common law duties, thus, may be adjusted by the terms of the contracts. For example, unless the parties have agreed that a tortious remedy is to be limited or excluded, [153] the scope of tortious duties will be consistent with the applicable contract otherwise.[154] Also, the scope of fiduciary duties can be defined by the contractual terms,[155] whether they are express or implied terms.[156] This is because fiduciary duties are not set to aid in enlarging the scope of contractual duties either.[157] The dominant role of contractual terms even goes further to embrace the 'contractual estoppel' between investment firms and sophisticated, commercial investors:

> '[t]here is no reason in principle why parties to a contract should not agree that a certain state of affairs should form the basis for the transaction, whether it be the case or not. […] The contract itself gives rise to an estoppel.'[158]

However, this overly 'documentary fundamentalism' would need a suitable control in order to prevent it from intruding into all transactions, whatever the size or

Stevens, 'Election Between Alternative Remedies' [1995] *Restitution Law Review* 117, at 117–122.

152 Alastair Hudson, *The Law of Finance* (2nd edn, Sweet & Maxwell, 2013), para. 10-18.

153 *Henderson v Merrett Syndicates Ltd (No. 1)* [1995] 2 A.C. 145, at 194.

154 *South Australian Asset Management Corporation v York Montague* [1997] A.C. 191, at 211.

155 *Kelly v Cooper* [1993] A.C. 205, at 215; *John Youngs Insurance Services Ltd v Aviva Insurance Service UK Ltd* [2011] EWHC 1515 (TCC); [2012] 1 All E.R. (Comm) 1045, para. 94(1).

156 Dick Frase, *Law and Regulation of Investment Management* (2nd edn, Sweet & Maxwell, 2011), para. 8-069.

157 *Clark Boyce v Mouat* [1994] 1 A.C. 428, at 437.

158 *Peekay Intermark Limited, Harish Pawani v Australia and New Zealand Banking Group Limited* [2006] EWCA Civ 386; [2006] 2 Lloyd's Rep. 511, para. 56; see also *Springwell Navigation Corp v JP Morgan Chase Bank (formerly Chase Manhattan Bank)* [2010] EWCA Civ 1221; [2010] 2 C.L.C. 705, para. 170.

sophistication of the counterparty.[159] Therefore, the Unfair Contract Terms Act 1977 ('UCTA') dealing with unfair contract terms might provide major protection. The UCTA requires that contractual provisions or non-contractual notices, which seek to exclude or restrict liability,[160] must satisfy a 'reasonable test'.[161] Furthermore, as mentioned by FCA's rules,[162] if the term is in a business-to-consumer contract, it would be subject to the Unfair Terms in Consumer Contracts Regulations 1999 ('UTCCR')[163] or the Consumer Rights Act 2015[164], depending on the contract entered into before 1 October, 2015 or later. These two regimes (namely, the unfair terms and the consumer protection regimes) have different scopes and different effects of application, but, to some extent, they overlap.[165] It is worth mentioning that the foregoing discussion is based on the cases of 'saying too much' in contractual terms. However, since (i) claims may arise in the negotiation phase; and (ii) investment firms, generally, do not define precisely the nature or standard of the investment services in contractual terms, disputes, in most cases, have to be resolved by reference to other default rules, such as duties of care and fiduciary duties.[166]

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159 Gerard McMeel, 'Documentary Fundamentalism in the Senior Courts: the Myth of Contractual Estoppel' [2011] *Lloyd's Maritime and Commercial Law Quarterly* 185, at 201–207.
160 In England and Wales and Northern Ireland, Sections 2–4 of UCTA; in Scotland, Section 16 of UCTA.
161 In England and Wales and Northern Ireland, Section 11 of UCTA; in Scotland, Section 24 of UCTA.
162 FCA Handbook COBS 2.1.3(2)G.
163 SI 1999/2083, as amended by SI 2001/1186 and SI 2001/3649. This legislation is national implementation of UCTD in the UK.
164 In particular, Part 2 of the Consumer Right Act 2015. For a comprehensive analysis of the Consumer Rights Act 2015: see Alec Samuels, 'The Consumer Rights Act 2015' (2016) *Journal of Business Law* 159, at 159–185.
165 Edwin Peel, *The Law of Contract* (13th edn, Sweet & Maxwell, 2011), paras. 7-096–7-099.
166 Iain G. MacNeil, *An Introduction to the Law on Financial Investment* (2nd edn, Hart Publishing, 2012), at 240–241.

4.2.2. Judge-Made Law: Duty of Care

Fundamentally, a duty of care is a 'management duty'[167] to act carefully in performing the tasks that have been undertaken, irrespective of whether the person is a fiduciary.[168] It is very likely to owe a duty of care when investment firms are providing investment services to their clients, although, in the USA, the courts classify the duty of care as a category of fiduciary duties,[169] but carelessness is not disloyalty.[170] As the House of Lords noted in *Hilton v Barker Booth & Eastwood*:

> 'if a solicitor is careless in investigating a title or drafting a lease, he may be liable to pay damages for breach of his professional duty, but that is not a breach of a fiduciary duty of loyalty; it is simply the breach of a duty of care.'[171]

To establish liability in negligence, the first requirement is to show that a duty of care exists.[172] Normally, it is well-established that a person who contracts with another to provide a service must provide the service with reasonable care and skill, which is 'the standard of the ordinary skilled man exercising and professing to have that special skill'.[173] However, this does not usually imply a warranty that the service provider will

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167 J. C. Shepherd, *The Law of Fiduciaries* (The Carswell Company Limited, 1981), at 48.

168 Matthew Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Hart Publishing, 2010), at 36.

169 Tamar Frankel, *Fiduciary Law* (Oxford University Press, 2011), at 169–177. For an opponent of this in the USA: see Larry E. Ribstein, 'Are Partners Fiduciaries?' (2005) *University of Illinois Law Forum* 209, at 220.

170 Parker Hood, *Principles of Lender Liability* (Oxford University Press, 2012), para. 5.26.

171 *Hilton v Barker Booth & Eastwood* [2005] UKHL 8; [2005] 1 W.L.R. 567, para. 29.

172 There are three conditions of establishing liability for negligence: (i) the defendant 'failed to exercise due care'; (ii) the defendant 'owed the injured man the duty to exercise due care'; and (iii) the defendant's failure to do so was 'the cause of the injury in the proper sense of the term': see *Overseas Tankship (UK) Ltd v Morts Dock & Engineering Co (The Wagon Mound)* [1961] A.C. 388, at 422. This thesis will discuss the first two elements only.

173 *Bolam v Friern Hospital Management Committee* [1957] 1 W.L.R. 582, at 586.

achieve the desired result.[174] This common law principle is embodied in Section 49 of the Supply of Goods and Services Act 1982: 'in a contract for the supply of a service where the supplier is acting in the course of a business, there is an implied term that the supplier will carry out the service with reasonable care and skill'. For those business-to-consumer contracts, the Section 49 of Consumer Rights Act 2015 will cover: '[e]very contract to supply a service is to be treated as including a term that the trader must perform the service with reasonable care and skill.' Furthermore, even where a contract is not in place, there could be 'a special relationship between the parties which imposed a duty to give careful advice'.[175] Based on this, investment firms, as professionals, might be taken to have assumed responsibilities towards their clients and owe a duty of care in tort and in contractual obligations simultaneously.[176] But, it should be noted that contractual and tortious duties have different origins and different functions.[177] This difference can be important for investors since the limitation period within which a cause of action can be brought starts to run at different times.[178] Likewise, the duty of care on trustees is written in a statutory form in Section 1 of the

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[174] *Greaves & Co. (Contractors) Ltd. v Baynham Meikle & Partners* [1975] 1 W.L.R. 1095, at 1100; *Nykredit Mortgage Bank Plc v Edward Erdman Group Ltd* [1997] 1 W.L.R. 1627, at 1631.

[175] *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] A.C. 465, at 523–524.

[176] *Robinson v PE Jones (Contractors) Ltd* [2011] EWCA Civ 9; [2012] Q.B. 44, paras. 74–76.

[177] Ibid, paras. 77–79.

[178] Jonathan Fisher and Maclcolm Waters, *The Law of Investor Protection* (2nd edn, Sweet & Maxwell, 2003), para. 32-026. For more differences between tortious and contractual obligations: see Hugh Beale, *Chitty on Contracts* (31st edn, Sweet & Maxwell, 2012), paras. 1-139–1-145. According to Sections 2 and 5 of the Limitation Act 1980, they both refer to 'six years from the date on which the cause of action accrued'. But, in case of tort, this date is 'not when the culpable conduct occurs, but when the plaintiff first sustains damage': See *Berney v Saul (t/a Thomas Saul & Co)* [2013] EWCA Civ 640; [2013] P.N.L.R. 26, para. 52, quoting p. 1630 of *Nykredit Mortgage Bank Plc v Edward Erdman Group Ltd* [1997] 1 W.L.R. 1627. Therefore, the limitation periods of them should be examined respectively: see *Aspect Contracts (Asbestos) Limited v Higgins Construction plc* [2015] UKSC 38; [2015] 1 W.L.R. 2961, paras. 21–22.

Trustee Act 2000,[179] although it may be limited by express provisions of the trust.[180] It requires a trustee:

> 'must exercise such care and skill as is reasonable in the circumstances, having regard in particular—(a) to any special knowledge or experience that he has or holds himself out as having, and (b) if he acts as trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession'.[181]

This Article of the Trustee Act 2000 may also be easily applied to investment firms when they are providing portfolio management services.

The standard associated with the duty of care is the second question. In order to underpin the well-established commercial life,[182] the standard of liability is 'commercially unacceptable conduct in the particular context'.[183] '[W]here there is more than one accepted market practice, […] [an investment firm] will not be negligent if he follows one of them'.[184] However, it should be noted that courts tend to protect retail clients more in cases of negligent investment advice. First, 'if the bank does give an explanation or tender advice, then it owes a duty to give that explanation or tender that advice fully, accurately and properly'.[185] Investment firms now have a 'clear explanation'

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179 For a comprehensive analysis of the Trustee Act 2000: see Alastair Hudson, *Equity and Trusts* (7th edn, Routledge, 2013), Ch. 9.2.
180 Schedule 1 of the Trustee Act 2000, para. 7.
181 Section 1 of the Trustee Act 2000.
182 Tony Dugdale, 'Investment Advice: Duty of Care and Breach of Duty' (2007) 23 *Professional Negligence* 114, at 117.
183 *Cowan de Groot Properties v Eagle Trust* [1992] 4 All E.R. 700, at 761; *Heinl v Jyske Bank (Gibraltar) Ltd* [1999] Lloyd's Rep. Bank 511, at 535; *Bank of Scotland v A Ltd* [2001] EWCA Civ 52; [2001] 1 W.L.R. 751, para. 29; *Tayeb v HSBC Bank Plc* [2004] EWHC 1529 (Comm); [2004] 4 All E.R. 1024, paras. 73 and 74.
184 *Riyad Bank v Ahli United Bank (UK) Plc* [2006] EWCA Civ 780; [2006] 2 All E.R. (Comm) 777, para. 65.
185 *Crestsign Ltd v National Westminster Bank Plc* [2014] EWHC 3043 (Ch); [2015] 2 All E.R. (Comm) 133,

duty to retail clients. Second, in a well-publicised case, *Verity & Spindler v Lloyds Bank plc*,[186] the trial judge took into account: (i) a lack of sophistication of the client, and (ii) the client's reliance on the service provider, in order to hold that there was an assumed duty of care regarding advice and there was a breach of duty.[187] Third, if the duty is to advise whether or not a course of action should be taken, the adviser must take reasonable care to consider 'all the potential consequences of that course of action'.[188] This broad range of considerations provides a wide safety net for advisees. Fourth, the Court of Appeal in *Gorham v British Telecommunications* said that the standard of care here is 'a duty to the investment advisor not to give negligent advice to retail clients that adversely affected their interests as the clients intended them to be'.[189] The commercially acceptable standard now turns to be an expectation of their retail clients, which is higher than the former. By contrast, courts hold the standard of commercial activity in case of providing execution-only investment services to non-retail clients.[190] In the wake of the global financial crisis of 2007–09, courts have, generally, proved less sympathetic to non-retail investors.[191] In many of the cases listed, the investment firms

para. 145 quoting p. 533 of *Cornish v Midland Bank Plc* [1985] 3 All E.R. 513.

[186] *Verity & Anor v Lloyds Bank plc* [1995] C.L.C. 1557.

[187] Ibid, at 1580–1581, 1587.

[188] *South Australia Asset Management Corp v York Montague Ltd* [1997] A.C. 191, at 214.

[189] *Gorham & Others v British Telecommunications Limited plc, The Trustees of the BT Pension Scheme, Standard Life Assurance Company* [2000] 1 W.L.R. 2129, at 2142.

[190] *Titan Steel Wheels Ltd v Royal Bank of Scotland plc* [2010] EWHC 211 (Comm); [2010] 2 Lloyd's Rep. 92, para. 96.

[191] See, e.g., *Peekay Intermark Ltd v Australia & New Zealand Banking Group Ltd* [2006] EWCA Civ 386; [2006] 2 Lloyd's Rep. 511; *Springwell Navigation Corp v JP Morgan Chase Bank (formerly Chase Manhattan Bank)* [2010] EWCA Civ 1221; [2010] 2 C.L.C. 705; *Titan Steel Wheels Ltd v Royal Bank of Scotland plc* [2010] EWHC 211 (Comm); [2010] 2 Lloyd's Rep. 92; *Bank Leumi (UK) Plc v Wachner* [2011] EWHC 656 (Comm); [2011] 1 C.L.C. 454; *Wilson v MF Global UK Ltd* [2011] EWHC 138 (QB); *Winnetka Trading Corp v Julius Baer International Ltd* [2011] EWHC 2030 (Ch); [2012] 1 B.C.L.C. 588; *Camerata Property Inc v Credit Suisse Securities (Europe) Ltd* [2012] EWHC 7 (Comm); [2012] 1 C.L.C. 234; *Standard Chartered Bank v Ceylon Petroleum Corp* [2012] EWCA Civ 1049; *IG Markets Ltd v Crinion* [2013] EWCA Civ 587; [2013] C.P. Rep. 41; *IG Index Ltd v Ehrentreu* [2013] EWCA Civ 95; [2013] L.L.R. 366; *Zaki v Credit Suisse (UK) Ltd*, [2013] EWCA Civ 14; [2013] 2 All E.R. (Comm) 1159; and *Al Sulaiman v Credit Suisse Securities (Europe) Ltd*, [2013]

had a 'contractual estoppel'[192] clause. Because there was no obligation accepted; there was no advice given; and, even there was advice given, there was no deemed reliance, the courts merely uphold the validity of such clauses and no liability to these investment firms.

Nevertheless, the above non-retail cases do not necessarily mean that there is no duty to provide accurate information to non-retail clients. A duty to provide accurate information and the duty to give careful investment advice should be distinguished, even the dividing line is difficult to draw in some cases.[193] In terms of the duty of care in providing accurate information, misrepresentation shall be mentioned here. In the context of investment services, pertinent questions may often arise as to whether advertising materials or the statements of salespersons can form the basis of an actionable representation.[194] If the answer is positive, there are no fewer than three possible grounds to claim the recovery: first, the breach of duty of care in whether tort or contractual obligations; second, the breach of warranty for representations which are incorporated as terms of agreements; and third, under Section 2(1) of the Misrepresentation Act 1967.[195]

EWHC 400 (Comm); [2013] 1 All E.R. (Comm) 1105.

192 See further in Section 4.2.1 above (p. 223).

193 *South Australia Asset Management Corp v York Montague Ltd* [1997] A.C. 191, at 214; *Walker v Inter-Alliance Group Plc (In Administration)* [2007] EWHC 1858 (Ch); [2007] Pens. L.R. 347, para. 30; and *Crestsign Ltd v National Westminster Bank Plc*, above note 185, para. 115.

194 Gerard McMeel and John Virgo, *McMeel and Virgo on Financial Advice and Financial Products* (3rd edn, Oxford University Press, 2014), paras. 6.06–6.17.

195 According to Section 2(1) of the Misrepresentation Act 1967: 'where a person has entered into a contract after a misrepresentation has been made to him by another party thereto and as a result thereof he has suffered loss, then, if the person making the misrepresentation would be liable to damages in respect thereof had the misrepresentation been made fraudulently, that person shall be so liable notwithstanding that the misrepresentation was not made fraudulently, unless he proves that he had reasonable ground to believe and did believe up to the time the contract was made the facts represented were true.' Since the burden of proof is reversed, this Article will almost always be more advantageous than others. However, it will not always be possible to sue under Section 2(1) of the Misrepresentation

4.2.3. Judge-Made Law: Fiduciary Duty

Since the fiduciary law is described as the 'holy grail'[196] to 'facilitate situationally-appropriate justice in ways that the ordinary laws of civil law obligations cannot',[197] breaches of fiduciary duties can be actionable in the client/investment firm relationship. A well-known definition of a fiduciary 'is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence'.[198] Specifically, albeit this classification of fiduciary relationships is not without criticism,[199] fiduciary relationships are said to arise in two circumstances: (i) status-based—where a relationship falls under recognised categories, and (ii) fact-based—where the particular facts and circumstances of a relationship drive it in a fiduciary character.[200] With regard to the client/investment firm relationship, the most relevant categories of the status-based circumstance are (i) trustee and beneficiary,[201] and (ii) principal and agent.[202] As to the fact-based circumstance, it may depend on a variety of investment services offered by investment firms since there

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Act 1967, because sometimes there is no contract but a special relationship (such as, fiduciary relationships). For a theoretical discussion about the relationships between these bases: see Ian Brown and Adrian Chandler, 'Deceit, Damages and the Misrepresentation Act 1967, s.2(1)' [1992] *Lloyd's Maritime and Commercial Law Quarterly* 40, at 40–72.

196 Leonard I. Rotman, 'Fiduciary Law's Holy Grail: Reconciling Theory and Practice in Fiduciary Jurisprudence' (2011) 91 *Boston University Law Review* 921, at 923.

197 Ibid, at 935.

198 *Bristol & West Building Society v Mothew* [1998] Ch. 1, at 18.

199 For example, Professor Miller argues this approach of fiduciary relationships lacks consistency and predictability. Paul B. Miller, 'A Theory of Fiduciary Liability' (2011) 56 *McGill Law Journal* 235, at 247–252

200 Robert Flannigan, 'The Fiduciary Obligation' (1989) 9 *Oxford Journal of Legal Studies* 285, at 286–287; P. D. Finn, 'The Fiduciary Principle' in T. G. Youdan (ed), *Equity, Fiduciaries and Trusts* (Carswell, 1989), at 32–33; Law Commission, *Fiduciary Duties and Regulatory Rules: A Consultation Paper* (Consultation Paper No. 124, 1992), paras. 2.4.3–2.4.8.

201 *Keech v Sandford* (1726) 25 E.R. 223; *Price v Blakemore* (1843) 49 E.R. 922.

202 *Lamb v Evans* [1893] 1 Ch. 218, at 229; *English v Dedham Vale Properties Ltd* [1978] 1 W.L.R. 93, at 110–111.

is no settled test.[203] Therefore, in practice, we need to examine the services provided by the investment firms in different situations in order to find out whether there is a fiduciary relationship.

First, those who provide advisory investment services may owe fiduciary duties to their clients.[204] Fiduciary duties may arise where a client is particularly dependent on that advice.[205] Therefore, where advice is provided by an investment firm as a specialist skilled personal services to a client with the expectation that the client will rely on that advice, there will normally be a fiduciary relationship.[206] For example, in *Lloyd's Bank v Bundy*, a special fiduciary relationship existed as a result of the reliance placed by a retail client on the advice given by a bank.[207] However, without such reliance, merely giving advice does not in itself give rise to a fiduciary relationship, because this is a general market transaction for selling advice.[208]

Second, investment firms providing portfolio-management investment services may also owe fiduciary duties to their clients. Some have argued that there is 'a particularly clear basis' for investment managers to owe fiduciary duties to their clients.[209] As Justice Moore-Bick said:

> 'it would be unusual for an investment manager acquiring and managing a portfolio of investments under a formal management agreement not to owe duties

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203 Matthew Conaglen, 'The Nature and Function of Fiduciary Loyalty' (2005) 121 *Law Quarterly Review* 452, at 455.
204 See, e.g., *Woods v Martins Bank* [1959] 1 Q.B. 55, at 72.
205 *Tate v Williamson* (1865-66) L.R. 1 Eq. 528, at 534.
206 Dick Frase, 'Conflicts of Interest' (2012) 97 *Compliance Officer Bulletin* 1, at 3.
207 *Lloyds Bank Ltd v Bundy* [1975] Q.B. 326, at 341–342.
208 *Barnes v Black Horse Limited* [2011] EWHC 1416 (QB); [2011] 2 All E.R. (Comm) 1130, para. 17; see also Larry E. Ribstein, 'Fencing Fiduciary' (2011) 91 *Boston University Law Review* 837, at 912–913.
209 D. Frase, above note 206, at 6.

of care and duties of a fiduciary nature to the other party to the agreement'.[210]

It is suggested that investment firms will generally be acting as fiduciaries when they are managing portfolios of assets on behalf of their clients.[211] This is because: (i) there is a custodial relationship between the manager and client, and (ii) there is the unilateral power conferred on the manager to take decisions.[212]

Third, whether fiduciary duties will arise when investment firms providing execution-only investment services is still unclear. Generally, a fiduciary relation exists 'whenever the plaintiff entrusts to the defendant a job to be performed, for instance, the negotiation of a contract on his behalf or for his benefit, and relies on the defendant to procure for the plaintiff the best terms available.'[213] Therefore, there is considerable authority holding that a broker who is engaged to buy or sell shares on behalf of his client may be subject to fiduciary duties when buying and selling.[214] For example, delivering share certificates to a broker with instructions to sell was held to give rise to a fiduciary relationship.[215] Some scholars also argue that an investment firm is obliged to seek 'best execution' for a client because that is a fiduciary activity.[216] However, on the contrary, courts recently consider that, where regulatory rules permit a participant to sell financial instruments to a professional client or eligible counterparty on an execution

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210 *Diamantides v JP Morgan Chase Bank* [2005] EWCA Civ 1612, para. 27.
211 A. Hudson, above note 152, para. 5-18.
212 Stuart Willey, 'Investment Management and Fiduciary Duties' in Dick Frase (ed), *Law and Regulation of Investment Management* (Sweet & Maxwell, 2004), para. 9-004.
213 *Reading v Attorney General* [1949] 2 K.B. 232, at 236.
214 *Erskine, Oxenford & Co. v Sachs* [1901] 2 K.B. 504, at 511–512, 516–518; *Armstrong v Jackson* [1917] 2 K.B. 822, at 826–827; *Christoforides v Terry* [1924] A.C. 566, at 571.
215 *Hancock v Smith* (1889) 41 Ch. D. 456, at 459–462.
216 See, e.g., Alastair Hudson, *Securities Law* (2nd edn, Sweet & Maxwell, 2013), para. 25-14.

only basis, there is no fiduciary duty.[217] Due to the absence of reliance within these transactions, some scholars also describe such transactions between clients and investment firms as 'arm's length' without fiduciary relationship.[218] But, it is still unsure whether courts will differentiate this standard in case that investment firms provide execution-only services to retail clients.

Since fiduciary relationships may exist between investment firms and their clients, the next question is about the content of fiduciary duties. Fiduciary duties are traditionally considered to proscribe conduct rather than prescribe it,[219] which focus on what a fiduciary should not do instead of what the fiduciary should do.[220] It is a mistaken assumption that all fiduciaries owe the same duties in all circumstances.[221] Fiduciary duties, in fact, are 'a flexible set of principles' to guide decision making,[222] whose scope depends on the nature of the relationship and the facts of the case.[223] There are two general principles for deciding this: (i) 'no conflict of interest' principle;[224] and (ii) 'no secret profits' principle.[225] In combination of these two principles, the irreducible core of fiduciary duties is the duty of loyalty:

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217 *JP Morgan Bank (formerly Chase Manhattan Bank) v Springwell Navigation Corp* [2008] EWHC 1186 (Comm), para. 573 (affirmed by the Court of Appeal in *Springwell Navigation Corp v JP Morgan Chase Bank (formerly Chase Manhattan Bank)* [2010] EWCA Civ 1221; [2010] 2 C.L.C. 705).

218 See I. G. MacNeil, above note 166, at 237–238.

219 John McGhee, *Snell's Equity* (33rd edn, Sweet & Maxwell, 2014), para. 7-011.

220 *Attorney-General v Blake Jonathan Cape Ltd.* [1998] Ch. 439, at 455; *Item Software (UK) Ltd v Fassihi* [2004] EWCA Civ 1244; [2004] B.C.C. 994, para. 41.

221 *Henderson v Merrett Syndicates Ltd (No.1)* [1995] 2 A.C. 145, at 206.

222 James Hawley, Keith Johnson and Ed Waitzer, 'Reclaiming Fiduciary Duty Balance' (2011) 4 *Rotman International Journal of Pension Management* 4, at 7.

223 *Re Coomber* [1911] 1 Ch. 723, at 729; *Kelly v Cooper* [1993] A.C. 205, at 214; *Henderson v Merrett Syndicates Ltd (No.1)* [1995] 2 A.C. 145, at 205.

224 'It was a rule of universal application that trustees could not enter into contracts in which their own interests might be in conflict with those of their constituents': see *Aberdeen Railway Co. v Blaikie* (1854) 17 D. (H.L.) 20, at 21.

225 'So decreed, that the lease should be assigned to the infant, and that the trustee should be indemnified from any covenants comprised in the lease, and an account of the profits made since the renewal': *Keech v Sandford* 25 E.R. 223, at 223–224.

'a fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal'.[226]

Furthermore, 'not every breach of duty by a fiduciary is a breach of fiduciary duty'.[227] Fiduciary duties sit alongside other statutory, equitable and common law duties that a fiduciary might owe, in order to guard against a fiduciary's temptation to breach other duties.[228] In particular, fiduciary duties are not a panacea for the complexity and professionalisation in commerce.[229] Therefore, many scholars argue that other available doctrines are also of potential importance in the relationship of client/investment firm: such as, undue influence or good faith in commercial transactions,[230] and an equitable concept of 'fraud on a power'.[231] These will be discussed in the next section.

4.2.4. Judge-Made Law: Other Doctrines

In addition to the duty of care and the fiduciary duties mentioned above, there are other doctrines (such as, undue influence, unconscionability, good faith, fraud on a power and confidentiality). First of all, some argue that the undue influence could be found easily, when financial instruments are sold in an unsuitable fashion, or are intrinsically unsuitable.[232] Although it was said to be indefinable,[233] the law of undue

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[226] *Bristol & West Building Society v Mothew* [1998] Ch. 1, at 18.
[227] Ibid, at 16.
[228] *Boston Deep Sea Fishing & Ice Co v Ansell* (1888) 39 Ch D 339, at 357; *Eden v Ridsdales Railway Lamp & Lighting Co Ltd* (1889) 23 Q.B.D. 368, at 371.
[229] P. J. Millett, 'Equity's Place in the Law of Commerce' (1998) 114 *Law Quarterly Review* 214, at 216–217.
[230] P. D. Finn, above note 200, at 6–24.
[231] Peter Watts, *Bowstead and Reynolds on Agency* (20th edn, Sweet & Maxwell, 2014), para. 6.036.
[232] A. Hudson, above note 152, para. 5-31.

influence is clarified and explained by the House of Lords in *Royal Bank of Scotland Plc v Etridge (No. 2)*:

> '[i]f the intention was produced by an unacceptable mean, which is regarded as an exercise of improper or "undue" influence, and the law hence will not permit the transaction to stand, whenever the consent thus procured ought not fairly to be treated as the expression of a person's free will'. [234]

Fiduciary duties and the doctrine of undue influence are commonly conflated,[235] but they are distinct.[236] On the one hand, the doctrine of undue influence does not apply to all fiduciary relationships,[237] and, on the other, not all relationships with undue influence are necessarily fiduciary relationships.[238] In practice, despite the scepticism about the utility of this divide,[239] the cases of undue influence might happen in two situations: one is the direct analogue of duress, called 'actual' undue influence; and another is called 'presumed' undue influence, where the parties are in a relationship in which related duties are imposed on one party towards the other.[240]

Second, the principle of unconscionability may provide another possibility. In case of unconscionability, 'the court has an undoubted jurisdiction to relieve against […] unequitable and unconscientious bargains'.[241] Even if some argue that the undue

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[233] *Allcard v Skinner* (1887) 36 Ch. D. 145, at 183.
[234] *Royal Bank of Scotland Plc v Etridge (No. 2)* [2001] UKHL 44; [2002] 2 A.C. 773, para. 7.
[235] See, e.g., *Holman v Loynes* (1854) 43 E.R. 510, at 516.
[236] Graham Moffat, Gerry Bean and Rebecca Probert, *Trusts Law: Text and Materials* (5th edn, Cambridge University Press, 2009), at 855.
[237] *Goldsworthy v Brickell* [1987] Ch. 378, at 401.
[238] *National Westminster Bank Plc v Morgan* [1985] A.C. 686, at 703.
[239] *Royal Bank of Scotland Plc v Etridge (No. 2)* [2001] UKHL 44; [2002] 2 A.C. 773, para. 92.
[240] *Barclays Bank Plc v O'Brien* [1994] 1 A.C. 180, at 189–190.
[241] *Earl of Chesterfield and Others Executors of John Spencer v Sir Abraham Janssen* (1751) 28 E.R. 82, at 100.

influence can be subsumed by the principle of unconscionability,[242] they are different: the former is worse than the latter since the party under undue influence is subordinate and does not purport to act independently.[243] These two doctrines, thus, are examined separately.[244] Specifically, this principle has three elements:

> '[f]irst, one party has been at a serious disadvantage to the other, whether through poverty, or ignorance, or lack of advice, or otherwise, so that circumstances existed of which unfair advantage could be taken; […] secondly, this weakness of the one party has been exploited by the other in some morally culpable manner; […] and thirdly, the resulting transaction has been, not merely hard or improvident, but overreaching and oppressive'.[245]

In practice, although the burden of justifying such an unconscionable transaction is on the weak party[246] (i.e. clients of investment services in this case), it is highly possible that this principle could be applied in some financial transactions. However, the application of this principle is narrowly conservative in the UK law[247] and is only of

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242 David Capper, 'Undue Influence and Unconscionability: A Rationalisation' (1998) 114 *Law Quarterly Review* 479, at 499–503; James Devenney and Adrian Chandler, 'Unconscionability and the Taxonomy of Undue Influence' (2007) *Journal of Business Law* 541, at 560; David Capper, 'Protection of the Vulnerable in Financial Transactions–What the Common Law Vitiating Factors Can Do for You' in Mel Kenny, James Devenney and Lorna Fox O'Mahony (eds), *Unconscionability in European Private Financial Transactions: Protecting the Vulnerable* (Cambridge University Press, 2010), at 182.

243 Rick Bigwood, *Exploitative Contracts* (Oxford University Press, 2003), at 400.

244 See, e.g., *Irvani v Irvani* [2000] 1 Lloyd's Rep. 412, at 492–495.

245 *Alec Lobb Garages Ltd v Total Oil Great Britain Ltd* [1983] 1 W.L.R. 87, at 94–95; see also *Boustany v Pigott* (1995) 69 P. & C.R. 298, at 303.

246 *Earl of Aylesford v Morris* (1872-73) L.R. 8 Ch. App. 484, at 492.

247 See, e.g., the Court of Appeal held a twenty-five year repayment mortgage that granted to a 72-year-old man (who is illiterate and had a poor understanding of English) for supporting his son to set up a supermarket is not unconscionable: *Portman Building Society v Dusangh* [2000] 2 All E.R. (Comm) 221, at 14–17; the Court of Appeal did not think it is unconscionable that a stockbroker lent £105,000 at 15% interest to an farmer for converting a farm into a nursing home, along with an attached acknowledgement to transfer a 50% share in any company or organisation which came to run the nursing home: *Jones v Morgan* [2001] EWCA Civ 995; [2001] Lloyd's Rep. Bank 323, paras. 35–42.

theoretical interest to scholars.[248]

Third, although a duty to negotiate in good faith is unworkable,[249] 'a theme that runs through our law of contract is that the reasonable expectations of honest men must be protected'.[250] The duty of good faith, thus, could provide another protection of the client/investment firm relationship in the UK. Even if there is no consistent conception of the contents of good faith,[251] a possible synonym is 'fair and open dealing' that is used to clarify a same term 'good faith' of UTCCR (or of the Consumer Rights Act 2015 if the contract entered into after 1 October, 2015).[252] Duties of good faith are frequently recognised without any presence of a fiduciary relationship or on the basis of fiduciary principles.[253] The duty of good faith does not exclusively belong to fiduciaries and should be classified as one duty other than a fiduciary duty, although this is not without opponent.[254] A 'seminal judgement'[255] is *Imperial Group Pension Trust Ltd v Imperial Tobacco Ltd*.[256] It was held that the employer, who does not owe any fiduciary duties with respect to the exercise of his power to give or withhold consent,[257] may still

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248 See, e.g., Lara McMurtry, 'Unconscionability and Undue Influence: An Interaction?' (2000) *Conveyancer and Property Lawyer* 573, at 579–581; James P. Devenney, 'A Pack of Unruly Dogs: Unconscionable Bargains, Lawful Act (Economic) Duress and Clogs on the Equity of Redemption' (2002) *Journal of Business Law* 539, at 541–546; Stephen A. Smith, *Contract Theory* (Oxford University Press, 2004), at 344–364.

249 *Walford v Miles* [1992] 2 A.C. 128, at 138.

250 *First Energy (UK) Ltd v Hungarian International Bank Ltd* [1993] B.C.C. 533, at 533.

251 Mindy Chen-Wishart, *Contract Law* (4th edn, Oxford University Press, 2010), at 359; Ewan McKendrick, *Contract Law: Text, Cases, and materials* (5th edn, Oxford University Press, 2010), at 504–515.

252 *Director General of Fair Trading v First National Bank Plc* [2001] UKHL 52; [2002] 1 A.C. 481, para. 17.

253 See, e.g., *Price v Bouch* (1987) 53 P. & C.R. 257, at 261; *Downsview Nominees Ltd v First City Corp Ltd* [1993] A.C. 295, at 317; *Abu Dhabi National Tanker Co v Product Star Shipping (The Product Star) (No.2)* [1993] 1 Lloyd's Rep. 397, at 404; *Yorkshire Bank Plc v Hall* [1999] 1 W.L.R. 1713, at 1728; *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd* (No.2) [2001] EWCA Civ 1047; [2001] 2 All E.R. (Comm) 299, para. 76; *Paragon Finance Plc (formerly National Home Loans Corp) v Nash* [2001] EWCA Civ 1466; [2002] 1 W.L.R. 685, para. 38; *Redwood Master Fund Ltd v TD Bank Europe Ltd* [2002] EWHC 2703 (Ch); [2006] 1 B.C.L.C. 149, para. 105.

254 See, e.g., *Vivendi SA v Richards* [2013] EWHC 3006 (Ch); [2013] B.C.C. 771, para. 143.

255 *Johnson v Unisys Ltd* [2001] UKHL 13; [2003] 1 A.C. 518, para. 24.

256 *Imperial Group Pension Trust Ltd v Imperial Tobacco Ltd* [1991] 1 W.L.R. 589.

257 Ibid, at 596.

owe an obligation to exercise his discretion in good faith,[258] since this obligation arises as an implied term in the contract,[259] and also on the basis of an implied limitation on the power.[260] Once some elements of bad faith exist (e.g., some dishonesty or improper motive), a breach of the duty of good faith is established.[261]

Fourth, a 'power' can be used in good faith, but for an improper purpose.[262] A person has a 'power' over property when he can dispose of property owned by others,[263] and a person having a 'power' must fairly and honestly execute it without having any ulterior object to be accomplished.[264] Since investment firms have a discretion in choosing investment targets, this may easily happen in the practice of portfolio management services. Unlike the excessive execution, which is known as 'going beyond the permitted bounds of a power',[265] where the purpose or intention goes beyond the scope of the power, it will constitute a 'fraud on the power'[266] (hence, an alternative label of this doctrine is 'proper purposes doctrine'[267]). The 'fraudulent appointment'[268] means that 'the power has been exercised for a purpose, or with an intention, beyond the scope of or not justified by the instrument creating the power'.[269] Indeed, clear distinctions between the duty of loyalty and the proper purposes doctrine are not always

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258 Ibid, at 598–599.
259 Ibid, at 597.
260 Ibid, at 597–598.
261 *Medforth v Blake* [2000] Ch. 86, at 103.
262 J. McGhee, above note 219, para. 10-020.
263 *Freme v Clement* (1881) 18 Ch. D. 499, at 504.
264 *Duke of Portland v Lady Topham* (1864) 11 E.R. 1242, at 1251.
265 *Pitt v Holt* [2013] UKSC 26; [2013] 2 A.C. 108, para. 60.
266 *Vatcher v Paull* [1915] A.C. 372, at 378; see also Geraint Thomas, *Thomas on Powers* (2nd edn, Oxford University Press, 2012), Ch. 9.
267 M. Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, above note 168, at 44.
268 *Pitt v Holt* [2013] UKSC 26; [2013] 2 A.C. 108, para. 62.
269 *Vatcher v Paull* [1915] A.C. 372, at 378.

easy to draw,[270] and the proper purposes doctrine, in practice, is based on the very similar fact which explains and justifies the application of the duty of loyalty.[271] However, the proper purposes doctrine applies to 'all powers',[272] whether fiduciary powers or personal (non-fiduciary) powers[273], or even powers in public law.[274]

Last but not least, an investment firm may use a 'Chinese wall', which is a contrivance within an organisation to ensure that some parts of that organisation do not allow a client's confidential information to become known to other parts of that organisation.[275] It is essential not to confuse the fiduciary duty with a separate duty to respect confidential information.[276] The Court of Appeal, in *Attorney General v Blake*, indicates the differences between these two duties as follows:

> 'the two relationships are not mutually exclusive. They may co-exist between the same parties at the same time. But, they generate different obligations [a obligation of confidence and a fiduciary duty of loyalty], and their duration may be different.'[277]

Obligations of confidentiality may arise outside of any fiduciary relationship,[278] and may endure after the relationship has ended.[279] For example, a non-fiduciary can be

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270 P. Watts, above note 231, para. 8-219.
271 R. C. Nolan, 'Controlling Fiduciary Power' (2009) 68 *The Cambridge Law Journal* 293, at 313.
272 Geriant Thomas and Alastair Hudson, *The Law of Trusts* (2nd edn, Oxford University Press, 2010), para. 11.01.
273 *Yorkshire Bank Plc v Hall* [1999] 1 W.L.R. 1713, at 1728; *Paragon Finance Plc (formerly National Home Loans Corp) v Nash* [2001] EWCA Civ 1466; [2002] 1 W.L.R. 685, para. 37. See also David Hayton, Paul Matthews and Charles Mitchell, *Underhill and Hayton Law of Trusts and Trustees* (18th edn, LexisNexis, 2010), paras. 1.76 and 1.77.
274 G. Thomas, above note 266, para. 9.04.
275 FCA Handbook SYSC 10.2.
276 *Arklow Investments Ltd v Maclean* [2000] 1 W.L.R. 594, at 600.
277 [1998] Ch. 439, at 454.
278 *Indata Equipment Supplies Ltd v ACL Ltd* [1998] F.S.R. 248, at 256.
279 *Bolkiah v KPMG* [1999] 2 A.C. 222, at 235; *Walsh v Shanahan* [2013] EWCA Civ 411; [2013] 2 P. & C.R.

under a duty of confidentiality, and can still put his own interests first.[280] Banks have a duty of confidentiality to customers,[281] but do not normally come under a fiduciary duty to a customer.[282] Furthermore, a duty of confidentiality can have a wider sphere to protect disclosure of government secrets and personal or private information, with the advent of the Human Right Act 1998.[283] Therefore, confidence is best analysed as a separate head of liability from fiduciary duties,[284] even the jurisdictional basis of the action for breach of confidence is still uncertainty and controversial.[285]

4.3. Conflict of Laws in Cross-Border Transactions

In the practice of providing investment services, terms of business or agreements with clients might typically be required to cover a clause regarding the conflict of laws.[286] The conflict of laws would decide whether the UK's courts shall be the forum of disputes resolution (choice-of-forum rules) and whether the UK's law shall be applied (choice-of-law rules).[287] Therefore, in addition to the foregoing substantive private law in the UK, the conflict of laws might be a particularly important issue in cross-border transactions in the EU. Unlike substantive private law, Article 81.2(c) of the TFEU

DG7, paras. 38 and 68.

280 P. Hood, above note 170, para. 5.32.

281 *Tournier v National Provincial and Union Bank of England* [1924] 1 K.B. 461, at 473.

282 *Bank of Scotland v A Ltd*, above note 180, para. 25.

283 *Campbell v Mirror Group Newspapers Ltd* [2004] UKHL 22; [2004] 2 A.C. 457, paras. 17 and 18; *OBG Ltd v Allan* [2007] UKHL 21; [2008] 1 A.C. 1, para. 118.

284 *Ratiu v Conway* [2005] EWCA Civ 1302; [2006] 1 All E.R. 571, para. 56; G. Moffat, G. Bean and R. Probert, above note 236, at 853; Tanya Aplin et al, *Gurry on Breach of Confidence: The Protection of Confidential Information* (2nd edn, Oxford University Press, 2012), para. 9.140.

285 See further in R. G. Toulson and C. M. Phipps, *Confidentiality* (3rd edn, Sweet & Maxwell, 2012), Ch. 2.

286 Philip R. Wood, *Regulation of International Finance* (2nd edn, Sweet & Maxwell, 2007), at 388–389; Matthias Lehmann, 'Financial Instruments' in Franco Ferrari and Stefan Leible (eds), *Rome I Regulation: The Law Applicable to Contractual Obligations in Europe* (Sellier, 2009), at 89–90.

287 It should be noted that, due to the fact that there are three legal systems within the UK, the conflict-of-law issues also happen within the UK, but this will not be tackled in this thesis. For a detailed analysis about the intra conflict-of-law issues in the UK: see Kirsty J. Hood, *Conflict of Laws Within the UK* (Oxford University Press, 2007).

provides a legal basis for unifying conflict of laws in the EU. The intra-European conflict of laws, thus, are laid down by Regulations,[288] as another type of 'regulatory tool'[289] for allocating competences of private law systems between Member States within the EU.[290] Since the UK opted in these Regulations,[291] the role of UK's national courts here is to interpret these EU statutes simply, and such interpretation shall be done in accordance with the guidance of the CJEU.[292] However, a conflict may still emerge between the MiFID regime and the intra-European conflict of laws, because it may not be easy to find an adequate balance between industry and consumer legitimate interests.[293]

4.3.1. Choice-of-Forum Rules: 2012 Brussels Regulation[294]

Since 10 January, 2015, the whole of the 'recast' Brussels Regulation[295] has been applied. The sole object of this Regulation 'is not to unify procedural rules but to determine which court has jurisdiction in disputes relating to civil and commercial

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288 Regulation (EU) No 1215/2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, 2012 OJ L351/1 ('Brussels Regulation'); Regulation (EC) No 593/2008 on the law applicable to contractual obligations (Rome I), 2008 OJ L177/6, which governs contractual obligations ('Rome I Regulation'); and Regulation (EC) No 864/2007 on the law applicable to non-contractual obligations, 2007 OJ L199/40. ('Rome II Regulation').

289 Horatia Muir Watt, 'Integration and Diversity: The Conflict of Laws as a Regulatory Tool' in Fabrizio Cafaggi (ed), *The Institutional Framework of European Private Law* (Oxford University Press, 2006), at 137–148.

290 Horatia Muir Watt, 'The Challenge of Market Integration for European Conflicts Theory' in Arthur Hartknamp et al (eds), *Towards a European Civil Code* (3rd edn, Kluwer Law International, 2004), at 191; Alex Mills, *The Confluence of Public and Private International Law* (Cambridge University Press, 2009), at 185.

291 See Recital 40 of Brussels Regulation; Commission Decision on the request from the United Kingdom to accept Regulation (EC) No 593/2008 on the law applicable to contractual obligations (Rome I), 2009 OJ L10/22; and Recital 39 of Rome II Regulation.

292 Lawrence Collins et al, *Dicey, Morris and Collins on the Conflict of Laws* (15th edn, Sweet & Maxwell, 2012), para. 2-007.

293 See further in Section 4.3.3 below (pp. 247–250).

294 In practice, many resources of the choice-of-forum rules might be applied in the EU, but, due to the limited space, this thesis would focus on Brussels Regulation only. For more discussion: see Trevor C. Hartley, *Choice-of-Court Agreements under the European and International Instruments: the Revised Brussels I Regulation, the Lugano Convention, and the Hague Convention* (Oxford University Press, 2013).

295 Article 81 of Brussels Regulation.

matters in intra-European relations and to facilitate the enforcement of judgments'.[296] According to this Regulation, clients and investment firms are free to choose the forum by an agreement, because 'the autonomy of the parties' shall be respected.[297] In order to neutralise the effect of jurisdiction clauses that might pass unnoticed in contracts,[298] such agreements must be agreed by the parties and 'clearly and precisely demonstrated',[299] and must be either in writing, in a form which accords with practices which the parties have established between themselves, or in a form which is widely known to any given international trading or commercial area.[300] Generally, in the absence of such agreements, an investment firm whose headquarters are in the UK shall be sued in the courts of the UK.[301] But, if disputes arising out of the operations of a branch, agency or other establishment, an investment firm may be sued in where the branch, agency or other establishment is situated;[302] if in matters relating to a contract, an investment firm may be sued in the courts where the services were provided (or should have been provided);[303] and if in matters relating to tort, delict or quasi-delict, a firm may be sued in the courts for the place where the harmful event occurred or may occur.[304] Given these varied choice-of-forum rules, an investment firm under the FCA's investment conduct supervision may be sued by clients in national courts of different

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296 CJEU, Case C-365/88, *Hagen v Zeehaghe*, [1990] ECR I-1845, para. 17.
297 Recital 19 of Brussels Regulation.
298 CJEU, Case 71/83, *Tilly Russ v Nova*, [1984] ECR 2417, para. 24.
299 CJEU, Case 24/76, *Estasis Salotti v Ruewa*, [1976] ECR 1831, para. 7; CJEU, Case 25/76, *Segoura v Bonakdarian*, [1976] ECR 1851, para. 6; CJEU, Case C-106/95, *MSG v Les Gravières Rhénanes*, [1997] ECR I-911, para. 15; CJEU, Case C-387/98, *Coreck Maritime GmbH v Handelsveem BV and Others*, [2000] ECR I-9337, para. 13.
300 Article 25.1 of Brussels Regulation.
301 Article 4.1 of Brussels Regulation.
302 Articles 7(5) of Brussels Regulation;
303 Article 7(1) of Brussels Regulation.
304 Article 7(2) of Brussels Regulation.

Member States.

Furthermore, weaker parties should be protected by the choice-of-forum rules more,[305] regardless of the defendant's domicile.[306] For example, where an investment firm, whose headquarter is in the UK, provides investment services (or pursues any other commercial or professional activities) to a consumer[307] domiciled in France through its French branch, the consumer shall claim his right at the French courts.[308] In another example, if such commercial or professional activities could be proven as the investment firm directing them to France (through a website or other e-commerce methods), the consumer may claim his rights at courts in either the UK or France.[309] As to the demonstration of whether the investment firm 'directs such activities' to France, it should consider relevant evidence in combination other than by only the domicile, such as, 'the international nature of the activity at issue', 'mention of telephone numbers with the international code', 'use of a top-level domain name' other than that of the Member State in which the investment firm is established, 'the description of itineraries from one or more other Member States to the place where the service is provided', 'mention of an international clientele composed of customers domiciled in various Member States', and 'the website permits consumers to use a different language or a different currency'.[310] In fact, it is not easy to answer this question in practice, so the legal certainty for consumers' choice is provided at the expense of legal uncertainty for

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305 Recital 18 of Brussels Regulation;

306 Recital 14 of Brussels Regulation.

307 It is important to note again that range of the term 'consumer' is not equal to the term 'retail investor'. See further in the footnote 128 of CHAPTER II (p. 35).

308 Articles 17.2 and 18.1 of Brussels Regulation.

309 Articles 17.1(c) and 18.1 of Brussels Regulation.

310 CJEU, Joined cases C-585/08 and C-144/09, *Pammer and Hotel Alpenhof*, [2010] ECR I-12527, paras. 81–84.

online businesses who bear significant costs of compliance with the complexity of the jurisdiction.[311] It is important to note that the above allocation of jurisdiction for protecting consumers is not absolute, which may be departed from by an agreement in accordance with specific conditions.[312] However, if a choice-of-forum clause is included, without being individually negotiated, in a contract between a consumer and an investment firm, with a conferral of exclusive jurisdiction on a court in the territorial jurisdiction of which the investment firm has 'his principal place of business', it must be regarded as 'unfair', as 'it causes, contrary to the requirement of good faith, a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer'.[313]

4.3.2. Choice-of-Law Rules: Rome I & II Regulations[314]

Rome I Regulation forms common choice-of-law principles of contractual obligations in the EU. The meaning of 'contractual obligations' are defined by the CJEU as legal obligations freely consented by one person towards another.[315] In terms of non-contractual obligations, they are governed by Rome II Regulation. The concept of

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311 Ksenija Vasiljeva, '1968 Brussels Convention and EU Council Regulation No 44/2001: Jurisdiction in Consumer Contracts Concluded Online' (2004) 10 *European Law Journal* 123, at 136.
312 Article 19 of Brussels Regulation.
313 CJEU, Joint Case C-240/98 to C-244/98, *Océano Grupo Editorial SA v Rocío Murciano Quintero* (240/98), and *Salvat Editores SA v José M. Sánchez Alcón Prades* (241/98), *José Luis Copano Badillo* (242/98), *Mohammed Berroane* (243/98) and *Emilio Viñas Feliú* (244/98), [2000] ECR I-04941, para. 24.
314 It is outside the scope to provide a comprehensive analysis of Rome Regulations in this thesis. For more discussion about Rome I Regulation: see Alexander J. Bělohlávek, *Rome Convention, Rome I Regulation (Commentary): New EU Conflict-of-Laws Rules for Contractual Obligations* (Juris, 2010); for Rome II Regulation: see Andrew Dickinson, *The Rome II Regulation: the Law Applicable to Non-Contractual Obligations* (Oxford University Press, 2010).
315 CJEU, Case C-26/91, *Handte v TMCS*, [1992] ECR I-3967, para. 15; CJEU, Case C-51/97, *Réunion européenne SA and Others v Spliethoff's Bevrachtingskantoor BV and the Master of the vessel Alblasgracht V002*, [1998] ECR I-6511, para. 17; CJEU, Case C-334/00, *Fonderie Officine Meccaniche Tacconi SpA v Heinrich Wagner Sinto Maschinenfabrik GmbH (HWS)*, [2002] ECR I-7357, para. 23; CJEU, Case C-265/02, *Frahuil SA v Assitalia SpA*, [2004] ECR I-1543, para. 24; CJEU, Case C-27/02, *Petra Engler v Janus Versand GmbH*, [2005] ECR I-481, para. 51.

'non-contractual obligations' varies from one Member State to another, so it should be understood as 'an autonomous concept'.[316] Given the fact that concurrent claims might occur easily in the UK, the substantive scope and the provisions of Rome II Regulation should be consistent with Rome I Regulation.[317] However, courts in the UK may encounter some difficulties in choosing applicable Regulations of the client/investment firm relationship,[318] in particular, equity-based obligations (such as, fiduciary duties) may be caught by either Rome I or Rome II Regulation in the UK. For example, pursuant to Articles 11 and 12 of Rome II Regulation, liabilities for management of business (*negotiorum gestio*) and pre-contractual dealings (*culpa in contrahendo*) are placed within the framework of Rome II Regulation. However, by contrast, Articles 12.1(c), (d) and (e) of Rome I Regulation indicate that restitutionary claims between the parties following the termination of a contract for breach or frustration, or to fix the consequences of its nullity, would fall in the scope of Rome I Regulation.

Notwithstanding the ambiguity of equity-based obligations, investment firms and their clients still can freely decide the applicable law in accordance with Rome Regulations.[319] In the absence of an agreement on choice of law, a contract for the provision of services shall be governed by the law of the country where the investment firm has his habitual residence,[320] where will be the branch, agency or any other establishment is located if the contract is concluded in the course of the operations of a

316 Recital 11 of Rome II Regulation.
317 Recital 7 and Article 4.3 of Rome II Regulation.
318 T. M. Yeo, *Choice of Law for Equitable Doctrines* (Oxford University Press, 2004), Chs. 7 and 8.
319 Article 3 of Rome I Regulation and Article 14 of Rome II Regulation.
320 Article 4.1(b) of Rome I Regulation.

branch, agency or any other establishment.[321] In terms of non-contractual obligations arising out of a tort/delict, the law of the country in which the damage occurs shall be applied generally.[322] Furthermore, weaker parties are protected more in Rome I Regulation.[323] For example, where an investment firm, whose headquarter is in the UK, pursues (or directs) commercial or professional activities to a consumer domiciled in France by a branch (or by e-commerce methods), the contractual obligations are governed by the law of France.[324] Recital 24 of Rome I Regulation also makes clear that the concept of 'direct activity' should be interpreted harmoniously with the Brussels Regulation.[325] By establishing this uniform choice-of-law rule between consumers and investment firms, it would provide 'more legal certainty–and thus, confidence–for the consumer who will know that the rules he knows best will apply to the legal relationship'.[326] One limitation of the above protection of consumers shall be mentioned: in case that a contract for the supply of services where the services are to be supplied to the consumer exclusively in a country other than that in which the consumer has his habitual residence, Rome I Regulation's consumer protection does not apply.[327] Therefore, if a consumer, who is resident in France, took a trip to the UK and bought investment services from an investment firm that are supplied in the UK exclusively, this contract is governed by the law of the UK. This is because, from the investment

321 Article 19.2 of Rome I Regulation.
322 Article 4.1 of Rome II Regulation.
323 Recital 23 of Rome I Regulation.
324 Recitals 25, 26 and Article 6 of Rome I Regulation.
325 Regulation (EU) No 1215/2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, 2012 OJ L351/1. See further in Section 4.3.1 above (pp. 241–244).
326 Commission of the European Communities, Green Paper on Retail Financial Services in the Single Market, COM(2007) 226 final, April, 2007, para. 31, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52007DC0226&from=EN> (accessed June, 2017).
327 Article 6.4(a) of Rome I Regulation.

firm's perspective, he may not know that the particular consumer actually resides in France, so he would surely expect that this contract would be subject to the UK law; from the consumer's perspective, he would assume that the law of the UK would be applied to the transaction when he bought services in the UK.[328] Again, the parties may still choose the law applicable to the contract in accordance with Article 3's freedom of choice in Rome I Regulation, but such a choice shall not have the result of depriving the protection of the consumer that he could have in the absence of the choice.[329]

4.3.3. Home Country Control versus Conflict of Laws

The preceding discussion indicates a significant conflict between the Single Passport regime in the MiFID regime and the conflict of laws in private law systems in the EU. Specifically, within the competence allocation of the MiFID regime, investment conduct of an investment firm, whose headquarter is in the UK, shall be regulated by the UK's regulatory rules and supervised by the FCA when it pursues (or directs) commercial or professional activities to consumers domiciled in other Member States through e-commerce methods.[330] But this investment firm might be sued by the consumers in different national courts, and so be governed by different national private laws. Private law obligations between investment firms and their clients will 'always provide a residual role' for host Member States' judicial authorities.[331] Given this, compared to the home country control of administrative regulation, conflict of laws

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[328] Christian Twigg-Flesner, "Good-Bye Harmonisation by Directives, Hello Cross-Border only Regulation?' – A way forward for EU Consumer Contract Law' (2011) 7 *European Review of Contract Law* 235, at 248.
[329] Article 6.2 of Rome I Regulation.
[330] See further in Section 2.1 of CHAPTER III (pp. 75–80).
[331] Emilios Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis* (Oxford University Press, 2005), at 300.

might be more complicated for investment firms to act safely in cross-border markets and creates enormous costs.[332]

In fact, many provisions of EU law imply this issue,[333] but this conflict becomes more remarkable in the Directive on electronic commerce ('ECD').[334] According to Article 3.1 of ECD, 'each Member State shall ensure that the information society services provided by a service provider established on its territory comply with the national provisions applicable in the Member State in question which fall within the coordinated field.' In terms of the 'coordinated field', Article 2(h)(i) broadly defines as all 'requirements regarding the quality or content of the service including those applicable to advertising and contracts, or requirements concerning the liability of the service provider.' Although the ECD's internal market clause does not aim to establish additional conflict-of-law rules,[335] and the Rome Regulations do not want to restrict the free movement of goods and services in the internal market,[336] ambiguity regarding the definition of the 'coordinated field' raises a debate about the relationship between norms of private international law and the principles of the internal market.[337] In order

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332 Norbert Reich et al, *European Consumer Law* (2nd edn, Intersentia, 2014), at 200.

333 See, e.g., Article 4.1(h) of Rome I Regulation; Recital 23 of KID Regulation; Recital 8 of Directive 2002/65/EC concerning the distance marketing of consumer financial services, 2007 OJ L319/1 ('DMD'); and Article 3.7 of Directive 2005/29/EC concerning unfair business-to-consumer commercial practices in the internal market, 2005 OJ L149/22. ('UCPD')

334 Directive 2000/31/EC on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market (Directive on electronic commerce), 2000 OJ L178/1. ('ECD')

335 Recital 23, Article 1.4 and Article 3.3 along with Annex of ECD.

336 Recital 40 and Article 23 of Rome I Regulation; Recital 35 and Article 27 of Rome II Regulation.

337 See, e.g., Norbert Reich and Axel Halfmeier, 'Consumer Protection in the Global Village: Recent Developments in German and European Union Law' (2001) 106 *Dickinson Law Review* 111, at 132–134; Michael Hellner, 'The Country of Origin Principle in the E-commerce Directive: A Conflict with Conflict of Laws?' (2004) 12 *European Review of Private Law* 193, at 194–213; Gert de Baere, 'Is this a Conflict Rule which I see Before Me? Looking for a Hidden Conflict Rule in the Principle of Origin as Implemented in Primary European Community Law and in the Directive on Electronic Commerce' (2004) 11 *Maastricht Journal of European and Comparative Law* 287, at 305–317; Ralf Michaels, *EU Law as Private International Law? Re-Conceptualising the Country-Of-Origin Principle as Vested Rights Theory* (ZERP Diskussionspapier 5/2006, 2006), at 12–16.

to resolve this debate, the CJEU confirmed that the country-of-origin principle 'does not establish additional rules on private international law relating to conflicts of laws',[338] because (i) Article 3.1 of ECD only 'leads to the application of the substantive law in force' in Member States[339]; and (ii) from Article 1(4) and Recital 23 of ECD, 'host Member States are in principle free to designate, pursuant to their private international law' as 'long as this does not result in a restriction of the freedom to provide electronic commerce services'.[340] In relation to the term 'coordinated field' of the provision, it principally precludes the provider of an e-commerce service from being made subject, in other Member States, to stricter requirements than those provided for by the substantive law of the Member State in which that service provider is established.[341] Thanks to this case law, the outstanding issue[342] between the internal market and the private international law is resolved partly.

However, the answer to this case law may not be able to end the conflict between the Single Passport regime and the conflict of laws entirely. In accordance with the CJEU's explanation in the *eDate Advertising and Others* case,[343] if choice-of-law rules have determined the law of host Member States to be the applicable law, the internal market clause can have a role to play in a second stage in the way this law is applied or interpreted. In other words, the choice-of-law rules shall still be interpreted in

338 CJEU, Joined Cases C-509/09 and C-161/10, *eDate Advertising GmbH v X* and *Olivier Martinez and Robert Martinez v MGN Limited*, [2011] ECR I-10269, para. 61.
339 Ibid, para. 62.
340 Ibid, para. 63.
341 Ibid, para. 68.
342 In fact, this debate first appeared in 1990s. For a probably first analysis on this issue: see Jan Wouters, 'Conflict of Laws and the Single Market for Financial Services (Part I)' (1997) 4 *Maastricht Journal of European and Comparative Law* 161, at 161–208; and Jan Wouters, 'Conflict of Laws and the Single Market for Financial Services (Part II)' (1997) 4 *Maastricht Journal of European and Comparative Law* 284, at 284–296.
343 CJEU, Joined Cases C-509/09 and C-161/10, above note 338.

accordance with the EU Treaties, since the choice-of-law rules do not exempt from the normative effects of the internal market provisions.[344] In the light of this, the Single Passport regime, which allocates competences to home Member States on the basis of the internal market, should be able to influence the European conflict of laws to some extent. Therefore, the interaction between the MiFID regime and European conflict of laws may remain controversial,[345] the effective use of the possibilities offered by the European Passport regime may be impaired, and the uniformity of investor protection at the EU level may be deterred.[346]

5. Co-ordination System of Private Law Governance in the Capital Markets Union

5.1. ESMA's Direct Supervision? Single Supervisor?

Given the aforementioned issues of the MiFID regime in private law systems, any approach to the implementation of EU policies has to secure the optimal interplay between administrative regulation and private law systems by appropriate coordination mechanisms.[347] As Professor Stefan Grundmann said:

> 'if indeed a European Capital Market Union were established, with far-reaching reforms, the relationship between regulation (supervision or market regulation) and private law could even become one of the core themes of

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344 A. Gkoutzinis, above note 18, at 146–159

345 Jean-Pierre Casey and Karel Lannoo, *The MiFID Revolution* (Cambridge University Press, 2009), at 189.

346 Michel Tison, *The Civil Law Effects of MiFID in a Comparative Law Perspective* (Ghent University Financial Law Institute Working Paper No WP 2010-05, 2010), at 13–17.

347 Geoffrey P. Miller and Fabrizio Cafaggi, *The Governance and Regulation of International Finance* (Edward Elgar Publishing, 2013), at 9–10; Olha O. Cherednychenko, 'In Search of Coherence in the Implementation of EU Policies: The Case of Financial Service Contracts' (5th Standing Group on Regulatory Governance (ECPR) Biennial Conference Regulatory Governance Between Global and Local, Barcelona, 25-27 June 2014), at 20.

discussion in the next decade'.[348]

This not only indicates the hybrid governance of investment conduct in the EU, but also highlights that, if the EU wants to reform, improve or render more coherent the dispersed rules, it should have an aerial view at all rules of European capital markets law.[349] Therefore, what we have to ask is whether centralised investment conduct supervision will be exactly the thing that the CMU needs, from the perspective of private law governance?

In order to answer this question, it is necessary to start with an examination of ESMA's influence on NCAs and national courts. There are two concerns. The first concern is ESMA's rule-making powers. Indeed, delegated and implementing Directives, technical standards, guidelines and recommendations are all useful to the implementation and enforcement of MiFID's rules, but these rule-making powers are limited to administrative regulation merely.[350] As discussed above,[351] national courts may take into account these regulatory rules as supportive evidence of private cases, but they have no obligation to follow these rules as NCAs. The second concern is ESMA's supervisory powers. Unlike NCAs, national courts will not feel bound by ESMA.[352] All ESMA's supervisory powers (such as, monitoring the application of EU law and binding mediation) could only be relevant to NCAs, not to national courts.[353] One special case,

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348 Stefan Grundmann, 'The Banking Union Translated into (Private Law) Duties: Infrastructure and Rulebook' (2015) 16 *European Business Organization Law Review* 357, at 379.

349 Brigitta Lurger, 'Old and New insights for the Protection of Consumers in European Private Law in the Wake of the Global Economic Crisis' in Roger Brownsword et al (eds), *The Foundations of European Private Law* (Hart Publishing, 2011), at 98–99.

350 See further in Section 3 of CHAPTER II (pp. 23–61).

351 See Section 4.1.3 above (pp. 219–221).

352 R. Veil, above note 78, at 422.

353 See further in Sections 3.2 and 3.3 of CHAPTER III (pp. 88–105).

however, should be followed up in the future is the product's restriction power newly conferred to ESMA by MiFIR.[354] If ESMA adopts a retroactive measure of specific products, this banning power may influence the contracts directly.[355] Notwithstanding this, ESMA is very unlikely to have such strong usage of this sensitive power in reality because of ESMA's constitutionality issue.[356] On the whole, ESMA provides very little help in co-ordinating private law governance of investment conduct. Therefore, it is highly doubtful that the establishment of a single supervisor will be able to reduce transactions costs of private law systems in the CMU more effectively.

5.2. Cross-Border Extra-Judicial Mechanism

In fact, such a multiplicity of jurisdictions and large variations of national private law across Member States may encourage the establishment of extra-judicial mechanism in cross-border transactions.[357] FIN-NET, which is a voluntary network of out-of-court complaint schemes handling disputes about financial services in the EU, is established to assist clients in transferring complaints to the competent alternative dispute resolution ('ADR') scheme in the country of the financial services provider.[358] However, the handling of complaints about financial services by this voluntary network may still be particularly problematic in a cross-border context.[359] As acknowledged by the

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[354] Article 40 of MiFIR: see further in Section 3.3.8 of CHPATER II (pp. 58–60) and Section 3.3.1 of CHAPTER III (p. 102).

[355] For example, according to Article 6(b)(iv)(2) of the ISDA 2002 Master Agreement, there is a right to terminate swaps and derivatives transactions following termination events due to illegality. By referring the definition of 'termination events' in Article 5(b)(i) along with the definition of 'law' in Article 14, ESMA's product restriction could possibly be seen as a transaction 'becomes unlawful under any applicable law' and classified as a termination event due to illegality.

[356] See further in Section 4.1 of CHAPTER III (pp. 105–117).

[357] N. Reich et al, above note 332, at 326–327.

[358] See more at the website of FIN-NET, available at: <http://ec.europa.eu/finance/fin-net/index_en.htm> (accessed June, 2017).

[359] For example, some Member States are still not FIN-NET members; ADR still does not exist in all Member States; and consumers are not aware of ADR schemes: see European Commission, Consultation

Commission,

> '[i]n the long run and in the event cross-border integration increases significantly, it might become necessary to think of additional measures to improve the ADR system in retail financial services'.[360]

Since ADR mechanisms could provide confidence of investors in buying cross-border investment services in the EU,[361] it might be needed to develop an enhanced pan-EU out-of-court mechanism in the CMU, in particular with the field of cross-border capital market disputes settlement. In addition to Article 81.2(g), Article 114 of the TFEU clearly has potential in developing cross-border dispute resolution and redress procedures.[362] Article 169.2 of the TFEU may also provide a legal basis to do so without the restriction of fiscal provisions, albeit its legal limits have never been tested.[363] In fact, the possibility of this is also confirmed by recent legislation. For example, according to MiFID II, Member States now have an obligation to 'ensure'—rather than merely 'encourage' or 'promote'—that efficient and effective

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Document: Alternative Dispute Resolution in the Area of Financial Services, MARKT/H3/JS D(2008), December, 2008, at 7–9, available at:
<http://ec.europa.eu/internal_market/consultations/docs/adr/adr_consultation_en.pdf>
(accessed June, 2017).
See also David Thomas and Francis Frizon, *Resolving Disputes between Consumers and Financial Businesses: Fundamentals for A Financial Ombudsman* (The World Bank, 2012), at 21–22.

360 European Commission, Green Paper on Retail Financial Services Better Products, More Choice, and Greater Opportunities for Consumers and Businesses, COM(2015) 630, December, 2015, at 19, available at:
<http://ec.europa.eu/finance/consultations/2015/retail-financial-services/docs/green-paper_en.pdf>
(accessed June, 2017).

361 Olha O. Cherednychenko, 'The Regulation of Retail Investment Services in the EU: Towards the Improvement of Investor Rights?' (2010) 33 *Journal of Consumer Policy* 403, at 412–414; Olha O. Cherednychenko, 'The Case of Securities Law' in F. Cafaggi et al (eds), *Europeanization of Private Law in Central and Eastern Europe Countries (CEECs): Preliminary Findings and Research Agenda* (EUI Working Papers, Law 2013/07, European University Institute, Department of Law, 2013), at 76–78.

362 Niamh Moloney, 'Investor Protection and the Treaty: an Uneasy Relationship' in Guido Ferrarini, Klaus J. Hopt and Eddy Wymeersch (eds), *Capital Markets in the Age of the Euro: Cross-Border Transactions, Listed Companies and Regulation* (Kluwer Law International, 2002), at 47.

363 N. Reich et al, above note 332, at 64–65.

complaints and redress procedures in the resolution of cross-border consumer disputes,[364] 'with a view to protecting clients and without prejudice to the right of customers to bring their action before the courts'.[365] The Consumer ADR Directive also requires appropriate ADRs in Member States to cover disputes arising from cross-border financial services.[366] Overall, there is a trend in the EU law to involve administrative authorities in the settlement of compensation claims, as a visible sign of administrative measures of private law.[367] The proposed ADR system of cross-border capital market disputes, thus, seems to be an area ripe for potential development through ESMA who could promote, advise on, and coordinate pan-EU movements towards.[368] The impact of ESMA's powers could be more incisive in such extra-judicial mechanisms, since arbitration is not bound by general private law and private international law.[369]

It is important to note that this proposed ADR mechanism in the CMU is not flawless. First, its function may be limited by investors' rational apathy, free riding and

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[364] Article 75 of MiFID II.

[365] Recital 151 of MiFID II.

[366] Recital 53 and Article 14.1 of Directive 2013/11/EU of the European Parliament and of the Council on alternative dispute resolution for consumer disputes and amending Regulation (EC) No 2006/2004 and Directive 2009/22/EC, 2013 OJ L165/63. ('Consumer ADR Directive')

[367] Fabrizio Cafaggi and Hans-W. Micklitz, 'Introduction' in Fabrizio Cafaggi and Hans-W. Micklitz (eds), *New Frontiers of Consumer Protection: The Interplay between Private and Public Enforcement* (Intersentia, 2009), at 12; Hans-W Micklitz, 'Administrative Enforcement of European Private Law' in Roger Brownsword et al (eds), *The Foundations of European Private Law* (Hart Publishing, 2011), at 564; F. D. Negra, above note 50, at 587–589; H.-W. Micklitz, 'The Transformation of Enforcement in European Private Law: Preliminary Considerations', above note 80, at 511–512; O. O. Cherednychenko, 'Public and Private Enforcement of European Private Law in the Financial Services Sector', above note 63, at 641–645.

[368] N. Moloney, 'Effective Policy Design for the Retail Investment Services Market: Challenges and Choices Post FSAP', above note 30, at 427; Jennifer Payne, 'The Way Forward in European Securities Regulation: Regulatory Competition or Mandatory Regulation' in Stephen Weatherill (ed), *Better Regulation* (Hart Publishing, 2007), at 385. See also Roberta S. Karmel, 'Case for a European Securities Commission' (1999) 38 *Columbia Journal of Transnational Law* 9, at 38.

[369] See Recital 12 and Article 1.2(d) of Brussels Regulation; and Article 1.2(e) of Rome I Regulation.

lack of confidence in its fairness.[370] Second, the current dispute resolution system in the EU law still lacks coherence and is fragmented.[371] Third, this self-sufficient ADR mechanism may have particularly deleterious consequences in relation to diversity of public policy objectives in Member States (such as, divergent needs of domestic consumer protection).[372] Therefore, national courts would still have to co-exist as complementary systems. Unless this proposed pan-EU ADR is a very attractive option,[373] clients would rather sue investment firms in their local courts.[374] By means of this double-track system, the relationship between administrative regulation and private law systems of investment conduct governance could be illustrated by Professor Micklitz's metaphor:

> '[t]he European rules governing the financial market are to be understood as a "silo" which contains public administrative rules on supervision and monitoring, on rule-making and rule enforcement, and last but not least on conflict resolution through ADR. European regulation, national implementing and enforcement rules are merging together in an amalgam of Europeanised national rules. The "silo" is closed and in principle self-standing. "Horizontally" applicable national private legal orders and national courts enter only when the "vertical" rules encapsulated

[370] Joasia Luzak, 'The ADR Directive: Designed to Fail? A Hole-Ridden Stairway to Consumer Justice' (2016) 24 *European Review of Private Law* 82, at 85–101.

[371] Eva Storskrubb, 'Alternative Dispute Resolution in the EU: Regulatory Challenges' (2016) 24 *European Review of Private Law* 7, at 25–30.

[372] Yane Svetiev, 'Introduction' in Yane Svetiev (ed), *Dimensions of Self-Sufficiency* (EUI Working Paper LAW 2013/05, 2013), at 3.

[373] For example, in Finland, national courts are marginalised by the dominance of ADRs in adjudication in the retail sector of financial services: see Iain G. MacNeil, 'Regulatory Rules and Private Claims' (2013) 7 *Law and Financial Markets Review* 67, at 67.

[374] Ruth Plato-Shinar and Rolf H. Weber, 'Consumer Protection through Soft Law in an Era of Global Financial Crisis' in Friedl Weiss and Armin J. Kammel (eds), *The Changing Landscape of Global Financial Governance and the Role of Soft Law* (Martinus Nijhoff, 2015), at 245–246.

in the silo turn out to be deficient in substance, or when the conflict cannot be kept within the boundaries of administrative monitoring, surveillance management or ADR conflict resolution.'[375]

6. Concluding Remarks

The function of private law systems in governing investment conduct in the EU has been examined comprehensively in this chapter. Due to its late development and Treaty limitations,[376] European private law is normally nationalised in Member States and very divergent in national private law systems (for instance, Member States develop their own ways to explain the term 'good faith' in Article 3 of UCTD). Under this decentralised model, even the harmonisation of MiFID's investment conduct rules is so dense and exhaustive, divergent national private laws and courts still have an important role to play in governing investment conduct. In the light of the UK's practice, the influence of MiFID's rules on private cases largely depends on the application of national courts. The UK's common law system takes centre stage in most cases and the MiFID's regime merely plays a supporting role. When tackling cross-border transactions relating to the UK, another complication with respect to the competence allocation is the interaction between the MiFID's Single Passport regime and the intra-European private international law. For example, investment conduct of an investment firm, whose headquarter is in the UK, shall be regulated by the UK's regulatory rules and supervised by the UK's supervisor when it pursues (or directs) commercial or

[375] Hans-Wolfgang Micklitz, 'The Public and the Private – European Regulatory Private Law and Financial Services' (2014) 10 *European Review of Contract Law* 473, at 474.

[376] In particular, Article 81 of the TFEU lists the measures that can be adopted by the EU exhaustively: see further in Section 2.2 above (pp. 197–199).

professional activities to consumers domiciled in other Member States through e-commerce methods. However, this investment firm might be sued by the consumers in different national courts, and so be governed by different national private laws. On the whole, many issues of private law in governing investment conduct are still unclear and complex, and these shall be resolved in order to build a solid CMU.

However, with regard to these issues, centralised supervision of investment conduct provides little help. National courts are not bound by ESMA (or even the proposed single supervisor), and the administrative authorities' opinion may only provide some supporting evidence to national courts in private law cases. Therefore, from the perspective of private law governance, it is highly doubtful that the establishment of a single supervisor could reduce the transaction costs of capital markets in the EU.[377] By comparison, a non-mandatory pan-EU ADR for cross-border capital market disputes is a more useful and feasible option in coordinating private law governance in the EU. Next to the judiciary, this ADR, as an important vehicle accelerating the Europeanisation in the CMU, could effectively ease the tension caused by multiplicity of jurisdictions and large variations of national private law.

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[377] As the first step, the Commission is preparing a campaign to raise awareness of FIN-NET: see European Commission, The Consumer Financial Services Action Plan, COM(2017) 139 final, March, 2017, at 4, available at: <http://eur-lex.europa.eu/resource.html?uri=cellar:055353bd-0fba-11e7-8a35-01aa75ed71a1.0003.02/DOC_1&format=PDF> (accessed June, 2017).

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CHAPTER VI

OPTIMUM ADMINISTRATIVE GOVERNANCE OF INVESTMENT CONDUCT IN THE CAPITAL MARKETS UNION

'The state is a two-edged sword: the existence of a state is essential for economic growth; the state, however, is the source of man-made decline.'[1]

'"Subsidiarity" is a two-edged sword. It can cut against Community action, but can also cut against state prerogatives.'[2]

1. Introduction

Given that centralised investment conduct supervision provides little help in reducing transaction costs in the CMU, from the perspective of private law governance,[3] this chapter is going to examine whether the argument in favour of centralised investment conduct supervision in the CMU could stand, from the perspective of administrative governance. In fact, the plea for a single supervisor in European capital markets is not a new idea—it is as old as the free movement of capital. The idea of single supervisor first appeared in the Segré report, which considered the establishment of an agency at the EU level similar to the US SEC in 1966.[4] The term, European

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[1] Douglass C. North, *Structure and Change in Economic History* (Norton, 1981), at 20.
[2] Thomas C. Fischer, 'Federalism in the European Community and the United States: A Rose by Any Other Name...' (1994) 17 *Fordham International Law Journal* 389, at 435.
[3] See further in Section 5.1 of CHAPTER V (pp. 250–252).
[4] Report of a Group of Experts appointed by the EEC Commission: The Development of A European Capital Market, November, 1966, at 235–238, available at: <http://aei.pitt.edu/31823/1/Dev_Eur_Cap_Mkt_1966.pdf> (accessed June, 2017).

Securities and Exchange Commission ('ESEC'), emerged in 1976,[5] with some followers.[6] The idea was appeared again in 1999 because of the commencement of the European Monetary Union ('EMU').[7] It then raised a long-lasting debate after the Lamfalussy report[8] published in 2001.[9] In fact, the Lamfalussy report envisaged the creation of EU supervisors as a possible development after the basic harmonised rules are in place.[10] This possibility was confirmed by the Prospectus Directive in 2003.[11] The de Larosière Report of 2009 also highlighted that an additional reform of ESFS might be considered: namely, moving towards a system that would rely on only two EU

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[5] Klaus J. Hopt, 'Third Theme: The Necessity of Co-ordinating or Approximating Economic Legislation, or of Supplementing or Replacing It by Community Law' (1976) 13 *Common Market Law Review* 231, at 249–251.

[6] See, e.g., Ruben Lee, 'Supervising EU Capital Markets: Do We Need A European SEC?' in R. M. Buxbaum et al (eds), *European Business and Economic Law* (Walter de Gruyter, 1996), at 187.

[7] See, e.g., Roberta S. Karmel, 'Case for a European Securities Commission' (1999) 38 *Columbia Journal of Transnational Law* 9, at 9–44.; Gilles Thieffry, 'Towards a European Securities Commission' (1999) 18 *International Financial Law Review* 14, at 14–18; David Green and Karel Lannoo, *Challenges to the Structure of Financial Supervision in the EU: Report of a CEPS Working Party* (Centre for European Policy Studies, 2000), at 18–19.

[8] European Commission, Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, February, 2001, available at: <http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf> (accessed June, 2017). ('Lamfalussy report')

[9] See, e.g., Gilles Thieffry, 'The Case For a European Securities Commission (ESC)' in Eilís Ferran and Charles A. E. Goodhart (eds), *Regulating Financial Services and Markets in the 21st Century* (Hart Publishing, 2001), at 211–234; Jeroen Kremers, Dirk Schoenmaker and Peter Wierts, 'Does Europe Need A Euro-Wide Supervisor?' (2001) 6 *The Financial Regulator* 50, at 50–56; Yannis Avgerinos, 'The Need and the Rationale for A European Securities Regulator' in Mads Andenas and Yannis Avgerinos (eds), *Financial Markets in Europe: Towards a Single Regulator?* (Kluwer Law International, 2003), Ch. 6; Gilles Thieffry, 'After the Lamfalussy Report: The First Step towards a European Securities Commission?' in Mads Andenas and Yannis Avgerinos (eds), *Financial Markets in Europe: Towards a Single Regulator?* (Kluwer Law International, 2003), Ch. 7; Gregor Pozniak, 'Towards a European Securities Commission: A View from the Securities Markets Industry' in Mads Andenas and Yannis Avgerinos (eds), *Financial Markets in Europe: Towards a Single Regulator?* (Kluwer Law International, 2003), Ch. 9; Eric J. Pan, 'The Case for a Single European Securities Regulator' in Mads Andenas and Yannis Avgerinos (eds), *Financial Markets in Europe: Towards a Single Regulator?* (Kluwer Law International, 2003), Ch. 10; Gerard Hertig and Ruben Lee, 'Four Predictions about the Future of EU Securities Regulation' (2003) 3 *Journal of Corporate Law Studies* 359, at 370–377; Rosa M. Lastra, 'The Governance Structure for Financial Regulation and Supervision in Europe' (2003) 10 *Columbia Journal of European Law* 49, at 54–56; Eilís Ferran, *Building an EU Securities Market* (Cambridge University Press, 2004), at 119–122; Pierre-Marie Boury, 'Does the European Union Need A Securities and Exchange Commission?' (2006) 1 *Capital Markets Law Journal* 184, at 191–194; Dorothee Fischer-Appelt, 'Does the EU Need A Single European Securities Regulator?' in Herwig C. H. Hofmann and Alexander H. Turk (eds), *EU Administrative Governance* (Edward Elgar, 2006), at 270–278.

[10] Lamfalussy report, above note 8, at 95.

[11] Recital 47 of Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, 2003 OJ L345/64.

authorities, which means the first authority would be responsible for banking and insurance prudential issues as well as for any other issue relevant for financial stability, and the second authority would be responsible for conduct-of-business and market issues.[12] A similar debate comes out again after the launch of the Action Plan of CMU, although SSM and ESMA are both in place now.[13] However, the preceding discussion does not differentiate investment conduct supervision from others, nor does it have a structured comparison of transaction costs. This is the task that this chapter aims to do.

With an aim to conduct a comprehensive transaction cost analysis focusing on investment conduct supervision, the rest of this chapter is divided into four sections. Section 2 explores the legal bases of the administrative governance in the EU Treaties. Based on the Treaty principles in the EU, Sections 3 and 4 further compare the total transaction costs between the current supervisory system and the proposed centralisation of investment conduct supervision. This institutional comparison is formed by the transaction cost approach:[14] environmental factors (uncertainty/complexity and small numbers) and human factors (opportunism and bounded rationality) are compared respectively. At the end, Section 5 concludes the outcome of this comprehensive institutional comparison.

[12] European Commission, Report of the High-Level Group on Financial Supervision in the EU, February, 2009, Rec. 24, available at: <http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf> (accessed June, 2017). ('De Larosière report')

[13] See Footnotes 21 and 22 of CHAPTER I (p. 4).

[14] See further in Sections 2 (pp. 135–146) and Section 3.2 (pp. 153–161) of CHAPTER IV.

2. Treaty Principles of European Administrative Governance

2.1. Principles of Conferral, Subsidiarity and Proportionality

As explored in the preceding chapters, the development of European capital markets regulation focuses on administrative measures largely.[15] However, even though administrative regulation enjoys a larger flexibility compared to private law systems in the EU law,[16] every action taken by the EU shall still be examined under the Treaties that have been approved voluntarily and democratically by all Member States. It is, thus, worthy to explore these Treaty bases before conducting a comparative institutional analysis.

First of all, according to the principle of conferral, the EU is only entitled to act within the competences conferred by Member States for the objectives set out in the Treaties.[17] This principle governs the 'limits' of the EU's competences.[18] In this sense, the EU enjoys no inherent sovereignty and is seen, for the most part, as a species of confederation.[19] The TFEU further distinguishes exclusive, shared, and supporting competences of the EU.[20] Policy areas that are not mentioned in Articles 3 and 6 of the TFEU would be classified into the type of shared competences.[21] Within the shared competences, the EU may legislate and adopt legally binding acts, but the competences

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[15] See further in Sections 2 and 3 of CHAPTER II (pp. 17–61) and CHAPTER III (pp. 75–105).
[16] See further in Section 2.2 of CHAPTER V (pp. 197–199).
[17] Article 5.2 of the TEU.
[18] Article 5.1 of the TEU.
[19] David Edward and Robert Lane, *Edward and Lane on European Union Law* (Edward Elgar, 2013), para. 2.26.
[20] Article 2 of the TFEU.
[21] Some explain this denial of exclusive competences was presumably because of the potential breadth of internal market measures: see Lorna Woods and Philippa Watson, *Steiner and Woods EU Law* (12th edn, Oxford University Press, 2014), at 58.

remain with Member States if the EU does not do so.[22] On the basis of this, investment conduct regulation falls into the shared competence (whether through the provisions of either 'internal market', 'consumer protection' or 'area of freedom'[23]) and the EU has legitimate powers to impose harmonised measures. But, the 'use' of the EU's competences is still governed by the principles of subsidiarity and proportionality.[24] If these two principles cannot be met, shared competences shall remain with Member States.[25]

Second, whether the EU could intervene in a shared competence is subject to the principle of subsidiarity.[26] Specifically, the test of this principle includes three steps: (i) to apply criteria chosen—this is the 'reason of scale or effects' test; (ii) to verify that credible co-operation between Member States is infeasible in the *status quo*—this is the 'cannot sufficiently achieved' test; and (iii) to confirm the EU's action can enforce this intervention better—the 'better achieved' test.[27] In order to clarify the 'dynamic concept' of the above three-stage test,[28] a more detailed protocol on subsidiarity is annexed to the Treaty of Amsterdam[29], indicating the following conditions should be examined:

> '(i) the issue under consideration has transnational aspects which cannot be satisfactorily regulated by action by Member States'; (ii) 'actions by Member States

22 Article 4.1 of TEU.
23 Articles 4(a), (f) and (j) of the TFEU.
24 Article 5.1 of the TEU.
25 Article 4.1 of the TEU.
26 Article 5.3 of the TEU.
27 Jacques Pelkmans, 'An EU subsidiarity test is indispensable' (2006) 41 *Intereconomics* 249, at 251.
28 Treaty of Amsterdam: Protocol on the application of the principles of subsidiarity and proportionality, 1997 OJ C 340/105, para. 3.
29 Treaty of Amsterdam amending the Treaty on European Union, the Treaties establishing the European Communities and related Acts, 1997 OJ C340/1.

alone or lack of EU's action would conflict with the requirements of the Treaty or would otherwise significantly damage Member States' interests'; and (iii) 'action at the EU level would produce clear benefits by reason of its scale or effects compared with action at the level of the Member States'.[30]

However, these criteria of the protocol, in fact, do no more that restate the problem, and they are not even clear whether these criteria are cumulative or alternative.[31] What we can confirm is that the principle of subsidiarity is a test of 'comparative efficiency' between different institutional arrangements of governance in the EU.[32]

Third, in addition to the principles of conferral and subsidiarity, the content and form of EU's action shall meet the principle of proportionality no matter in any kind of competences, in order to define the action assigned to the EU is not exceed what is 'necessary to achieve' the object of the EU.[33] As per the CJEU's ruling case in *Fedesa* case,[34] four stages are generally acknowledged to assure that the EU's measures are commensurate with its objectives: (i) a measure is in pursuit of a legitimate objective; (ii) the measure must be suitable to achieve the objective (the suitability test); (iii) the measure must be necessary to achieve the objective, which means there cannot be any less onerous way of doing it (the necessity test); and (iv) the measure must be reasonable,

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[30] Treaty of Amsterdam: Protocol on the application of the principles of subsidiarity and proportionality, above note 28, para. 5.
[31] L. Woods and P. Watson, above note 21, at 60.
[32] Commission Communication to the Council and Parliament, Bulletin EC 10-1992 (27, October 1992), at 116. See also Andreas Føllesdal, 'Subsidiarity' (1998) 6 *Journal of Political Philosophy* 190, at 193.
[33] Article 5.4 of the TEU.
[34] CJEU, Case C-331/88, *The Queen v Minister of Agriculture, Fisheries and Food and Secretary of State for Health, ex parte: Fedesa et al.*, [1990] ECR I-4023, para. 13.

considering competing interests and disadvantages (the proportionality *stricto sensu* test).[35] Furthermore, according to the protocol annexed to the Treaty of Amsterdam, EU's measures should provide Member States with alternative ways to achieve the objectives of the measures.[36] Conceptually, the principle of subsidiarity is an assessment of the 'need' for the EU's action, and the principle of proportionality is a determination of the 'nature' and 'intensity' of the EU's action.[37] However, this distinction is blurred in practice, since the objective of action and the means to pursue the objective cannot be separated clearly.[38] As some commentators claim, the wording 'in so far as' within the principle of subsidiarity 'embodies a specific application of the principle of proportionality' for protecting national powers.[39] Due to the blurring of the line between the two principles, the protocol on the application of the principles of subsidiarity and proportionality annexed to the Treaty of Lisbon no longer contains the concrete guidance and just 'conflates' these two principles:[40]

> 'the reasons for concluding that a EU objective can be better achieved at the

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[35] Tor-Inge Harbo, 'The Function of the Proportionality Principle in EU Law' (2010) 16 *European Law Journal* 158, at 165; Paul Craig and G. de Búrca, *EU Law: Text, Cases, and Materials* (Fifth edn, Oxford University Press, 2011), at 526; Wolf Sauter, 'Proportionality in EU Law: A Balancing Act?' (2013) 15 *Cambridge Yearbook of European Legal Studies* 439, at 448; HM Government, Review of the Balance of Competences between the United Kingdom and the European Union: Subsidiarity and Proportionality, December, 2014, at 35–36, available at: <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/388852/BoCSubAndPro_acc.pdf> (accessed June, 2017).

[36] Treaty of Amsterdam: Protocol on the application of the principles of subsidiarity and proportionality, above note 28, para. 6.

[37] Koen Lenaerts, 'The Principle of Subsidiarity and the Environment in the European Union: Keeping the Balance of Federalism' (1994) 17 *Fordham International Law Journal* 846, Part II.

[38] Gráinne De Búrca, 'The Principle of Subsidiarity and the Court of Justice as an Institutional Actor' (1998) 36 *Journal of Common Market Studies* 217, at 220; Sionaidh Douglas-Scott, *Constitutional Law of the European Union* (Longman, 2002), at 185.

[39] Koen Lenaerts et al, *European Union Law* (3rd edn, Sweet & Maxwell, 2011), para. 7-039; Takis Tridimas, *The General Principles of EU Laws* (2nd edn, Oxford University Press, 2007), at 176.

[40] Damian Chalmers, Gareth Davies and Giorgio Monti, *European Union Law: Text and Materials* (3rd edn, Cambridge University Press, 2014), at 393.

EU level shall be substantiated by qualitative and, wherever possible, quantitative indicators'; and (ii) 'draft legislative acts shall take account of the need for any burden, whether financial or administrative, falling upon the EU, national governments, regional or local authorities, economic operators and citizens, to be minimised and commensurate with the objective to be achieved'.[41]

Both of the principles of subsidiarity and proportionality together amount to nothing more than an economic analysis of (de)centralisation.[42]

In the light of this, the principles of subsidiarity and proportionality set in the EU Treaties[43] are in line with the long-standing argument of federalism economists: first, the principle of subsidiarity is commonly considered to be rooted in the theory of federalism,[44] which is concerned with understanding 'which functions and instruments are best centralised and which are best placed in the sphere of decentralised levels of government';[45] and second, the principle of proportionality also embeds the theory of federalism into its assessment.[46] Professor Van den Bergh, based on the federalism theory, establishes a consolidated analysis of competence allocation in relation to

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41 Lisbon Treaty, Protocol on the Application of the Principles of Subsidiarity and Proportionality, 2007 OJ C306/150, Article 5.

42 Jacques Pelkmans, *Testing for Subsidiarity* (Bruges European Economic Policy Briefings no 13, 2006), at 2.

43 Namely, the Treaty on European Union ('TEU') and the Treaty on the Functioning of the European Union ('TFEU').

44 See, e.g., Paul D. Marquardt, 'Subsidiary and Sovereignty in the European Union' (1994) 18 *Fordham International Law Journal* 616, at 618–625; George A. Bermann, 'Taking Subsidiarity Seriously: Federalism in the European Community and the United States' (1994) 94 *Columbia Law Review* 331, Part I; Koen Lenaerts, 'Federalism: Essential Concepts in Evolution - The Case of European Union' (1998) 21 *Fordham International Law Journal* 746, at 780–781. See further in Section 4 below (pp. 275–300).

45 Wallace E. Oates, 'An Easy on Fiscal Federalism' (1999) 37 *Journal of Economic Literature* 1120, at 1120.

46 Gabrielle Appleby, 'Proportionality and Federalism: Can Australia Learn from the European Community, the US and Canada' (2007) 26 *University of Tasmania Law Review* 1, at 20.

regulatory governance in the EU's multi-level system.[47] Regulation should be carried out by Member States, unless there is a justification for action to be taken at the EU level.[48] Thus, '[f]or an economist, … [o]nly indivisibilities, economies of scale, externalities, and strategic requirements are acceptable as efficiency arguments in favour of allocating powers to higher levels of government.'[49] In other words, any institutional change towards higher level of Europeanisation shall be justified by comparatively lower total transaction costs, in order to pass the tests in the principles of subsidiarity and proportionality.

2.2. Appropriate Level of Europeanisation

Given that: (i) the principle of subsidiarity recognises the capacities of a variety of actors at different levels, and (ii) the principle of proportionality supports the search for less intrusive governance, the legal bases of EU Treaties provide potential for developing a wider range of institutional governance.[50] This wide range of institutional governance can further be categorised on a scale ranging from the 'lightest' to the 'strongest' levels of Europeanisation: namely, (i) NCAs, (ii) networks of NCAs, (iii)

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[47] See Roger Van den Bergh, 'The Subsidiarity Principle in European Community Law: Some Insights from Law and Economics' (1994) 1 *Maastricht Journal of European and Comparative Law* 337, at 337–366; Roger Van den Bergh, 'Economic Criteria for Applying the Subsidiarity Principle in the European Community: The Case of Competition Policy' (1996) 16 *International Review of Law and Economics* 363, at 363–383; Roger Van den Bergh, 'Subsidiary as an Economic Demarcation Principle and the Emergence of European Private Law' (1998) 5 *Maastricht Journal of European and Comparative Law* 129, at 129–152; Roger Van den Bergh, 'Towards an Institutional Legal Framework for Regulatory Competition in Europe' (2000) 53 *Kyklos* 435, Appendix.

[48] Alex Mills, 'Federalism in the European Union and the United States: Subsidiarity, Private Law, and the Conflict of Laws' (2011) 32 *University of Pennsylvania Journal of International Law* 369, at 377.

[49] Tommaso Padoa-Schioppa, 'Economic Federalism and the European Union' in Sylvia Ostry et al (eds), *Rethinking Federalism: Citizens, Markets, and Governments in a Changing World* (University of British Columbia Press, 1995), at 155.

[50] Colin Scott, 'The Governance of the European Union: The Potential for Multi-Level Control' (2002) 8 *European Law Journal* 59, at 64–66.

European agencies, and (iv) European institutions.[51] An initial European response to the challenges of integration and subsidiarity is the model of transnational regulatory networks.[52] On the one hand, the consistency in application of the EU law could be achieved by establishing networks of NCAs.[53] On the other hand, by taking into account the principle of subsidiarity, networks of NCAs are a halfway solution between decentralisation and centralisation with a double delegation: one 'upwards' from NCAs and second 'downwards' from the Commission.[54] These networks keep the benefits of decentralisation and offer safeguards to the problems of decentralisation simultaneously.[55] Therefore, in order to maintain the institutional balance within the Treaties, EU networks remain their important roles for the function of EU financial markets. However, due to the perils of politicisation, the credibility of regulatory commitments as well as the institutional deficits and gaps of the pan-EU regulation, the need for European agencies is undisputed in some fields where networks cannot function well.[56] The creation of independent European agencies and 'Euro-regulators' are two further options for stronger consistent supervision of EU law.[57] ESMA and SSM, for example, are two major cases upwards higher level of Europeanisation in

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[51] Annetje Ottow, 'Europeanization of the Supervision of Competitive Markets' (2012) 18 *European Public Law* 191, at 193–194.

[52] Giandomenico Majone, 'The Credibility Crisis of Community Regulation' (2000) 38 *Journal of Common Market Studies* 273, at 295.

[53] Asen Lefterov, 'How Feasible Is the Proposal for Establishing a New European System of Financial Supervisors?' (2012) 38 *Legal Issues of Economic Integration* 33, at 55–57.

[54] David Coen and Mark Thatcher, 'Network Governance and Multi-Level Delegation: European Networks of Regulatory Agencies' (2008) 28 *Journal of Public Policy* 49, at 50.

[55] Pierre Schammo, 'EU Day-to-Day Supervision or Intervention-Based Supervision: Which Way Forward for the European System of Financial Supervision?' (2012) 32 *Oxford Journal of Legal Studies* 771, at 791–793.

[56] Giandomenico Majone and Michelle Everson, 'Institutional Reform: Independent Agencies, Oversight, Coordination and Procedural Control' in Olivier De Schutter, Notis Lebessis and John Paterson (eds), *Governance in the European Union* (European Communities, 2001), at 130–140.

[57] Mark Thatcher and David Coen, 'Reshaping European Regulatory Space: An Evolutionary Analysis' (2008) 31 *West European Politics* 806, at 825–827.

European financial markets.[58] Compared to EU networks, the constitutionality issue of these two types of institutional governance is more sensitive.[59] They may face more challenges from the principles of subsidiarity and proportionality.

In practice, concrete steps towards the strongest Europeanisation of the Eurozone's supervisor in financial markets are very recent, because the political consensus for the creation of SSM by Article 127.6 of the TFEU was agreed in 2012 within the plan of EBU.[60] Since November, 2014, the ECB has become a centralised supervisor for the Euro area's large credit institutions, and the broader prudential supervision of Eurozone banks is centralised to ECB.[61] SSM, which is restricted in the banking business and the Eurozone only, reflects a traditional and overly-narrow view of the sources of systemic risks,[62] but it opens a new chapter of Europeanisation. There are three ways to make prudential supervisory powers more 'centralised' in SSM. First, the ECB can issue a binding instruction addressed to respective NCAs, and NCAs, in turn, follow the instruction by addressing decisions to private individuals or

58 Annetje Ottow, 'The New European Superviosry Architecture of the Financial Markets' in Michelle Everson, Cosimo Monda and Ellen Vos (eds), *European Agencies in between Institutions and Member States* (Kluwer Law International, 2014), at 138–142.
59 For detailed discussion about the constitutionality issues of European agencies: see Section 4.1 of CHAPTER III (pp. 105–117).
60 Council Regulation (EU) No 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, 2013 OJ L287/63 ('SSM Regulation'); Regulation (EU) No 1022/2013 of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013, 2013 OJ L287/5.
61 Rosa M. Lastra, 'Banking Union and Single Market: Conflict or Companionship' (2013) 36 *Fordham International Law Journal* 1190, at 1192; see also Articles 5 and 6 of SSM Regulation.
62 Eilís Ferran and Valia SG Babis, 'The European Single Supervisory Mechanism' (2013) 13 *Journal of Corporate Law Studies* 255, at 259; Danny Busch and Guido Ferrarini, 'A Banking Union for a Divided Europe: An Introduction' in Danny Busch and Guido Ferrarini (eds), *European Banking Union* (Oxford University Press, 2015), para. 1.02; Eilís Ferran, 'European Banking Union: Imperfect, But It Can Work' in Danny Busch and Guido Ferrarini (eds), *European Banking Union* (Oxford University Press, 2015), para. 3.12.

corporations from the EU law.[63] The ECB works as a 'supervisors' supervisor' of the pan-EU market with intervention powers in this case.[64] Second, the ECB has direct powers and could take legally binding measures vis-à-vis private individuals or corporations from EU law,[65] as a 'direct supervisor' of the pan-EU market. Third, there might be an unprecedented way established by Article 4.3 of SSM Regulation, i.e., an application of 'national legislation' (rather than the EU law) by the ECB to private individuals or corporations.[66] This novelty may be a striking step for the European integration project,[67] but its administrative and judicial reviews are still in question and need more clarification in the future practice.[68]

Although the upward trend of centralised financial supervision in the EU is underway, a counter-trend (namely, decentralisation) in the field of competition policies cannot be ignored. Since 2004, the Directorate General for Competition embedded in the European Commission ('DG COM') has been exercising its supervisory power in the EU with the support of European Competition Network ('ECN') in Member States.[69] In this model, the DG COM remains its centralised supervisory powers to ensure the application of the principles laid down in Articles 101 and 102 of the TFEU, in conformity with the legal basis of Article 105.[70] Yet, the EU's antitrust governance

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63 Articles 6.3 and 6.5(a) of SSM Regulation.

64 Klaus Lackhoff, 'How Will the Single Supervisory Mechanism (SSM) Function? A Brief Overview' (2013) 29 *Journal of International Banking Law and Regulation* 13, at 21.

65 CHAPTER III of SSM Regulation.

66 Recital 34 of SSM Regulation.

67 A. Witte, 'The Application of National Banking Supervision Law by the ECB: Three Parallel Modes of Executing EU Law?' (2014) 21 *Maastricht Journal of European and Comparative Law* 89, at 105–109.

68 Tomas M. C. Arons, 'Judicial Protection of Supervised Credit Institutions in the European Banking Union' in Danny Busch and Guido Ferrarini (eds), *European Banking Union* (Oxford University Press, 2015), paras. 13.30 and 13.25.

69 Council Regulation (EC) No 1/2003 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty, 2003 OJ L1/1.

70 Suzanne Kingston, 'A "New Division of Responsibilities" in the Proposed Regulation to Modernise

apparatus relies on a decentralised structure of parallel enforcement of the law, and the DG COM only focuses on European significant cases and co-ordinates national authorities in the application of EU laws.[71] By means of this, national supervisory structures, including their expertise and knowledge, would be fully incorporated into the supranational system, so the need for human and financial resources to manage the supervisory tasks of the EU could be minimised.[72] Compared to the full centralisation, there would be a great benefit in adopting this complementarity model for supervision.

In sum, given the above two examples in the EU, centralisation and decentralisation have their own strengths and weaknesses. This is not always the case for strongest centralisation in the EU. As some argue, 'decentralisation is neither good nor bad for efficiency, equity, or macroeconomic stability; but rather that its effects depend on institution-specific design.'[73] Therefore, the EU Treaties guarantee a comprehensive institutional comparison in order to prevent any undue movement of Europeanisation.

3. 'Cannot be Sufficiently Achieved' Test

As discussed in CHAPTER III, in terms of investment conduct supervision of cross-border transactions, one of the major challenges in the current system is the

the Rules Implementing Articles 81 and 82 EC? A Warning Call' (2001) 22 *European Competition Law Review* 340, at 344; Rein Wesseling, 'The Draft-Regulation Modernising the Competition Rules: the Commission is Married to One Idea' (2001) 26 *European Law Review* 357, at 375.

[71] Alexander Türk, 'Modernisation of EC Antitrust Enforcement' in Herwig Hofmann and Alexander Türk (eds), *EU Administrative Governance* (Edward Elgar, 2006), at 215–243.

[72] Jacopo Carmassi, Carmine Di Noia and Stefano Micossi, *Banking Union: A Federal Model for the European Union with Prompt Corrective Action* (CEPS Policy Brief, No 282, 2012), at 5.

[73] Jennie Litvack, Junaid Ahmad and Richard Bird, *Rethinking Decentralization in Developing Countries* (The World Bank, 1998), at vii.

co-operation issue between NCAs.[74] For example, on the one hand, NCAs of home Member States may ignore host Member States' benefits if they can escape the costs of supervisory failures, and, on the other hand, NCAs of host Member States may have few incentives to invest in adequate supervision if NCAs of home Member States are given the leading role and are presumed to take it. Indeed, one candidate solution of this co-operation issue is to create a supranational supervisor to supervise investment firms in more than one country. However, this issue could alternatively be resolved by successful bargaining between the affected parties,[75] without the need of centralisation.

From the viewpoint of co-operative federalism, the primary function of the central government is to encourage and enforce inter-jurisdictional co-operation.[76] This idea is embedded in the principle of sincere co-operation of the TEU, which requires 'the Union and the Member States shall, in full mutual respect, assist each other in carrying out tasks which flow from the Treaties,'[77] as an expression of the EU's solidarity.[78] In accordance with this principle, Member States have: (i) a positive obligation to take all appropriate measures to fulfil the obligations of the EU law,[79] and (ii) a negative obligation to refrain from any measure which could jeopardise the attainment of the EU's objectives.[80] These obligations are 'binding on all the authorities of Member

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[74] See further in Section 4.3.2 of CHAPTER III (pp. 125–128).
[75] Ronald H. Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1, at 3–15; Antonio Estache, J. Cremer and Paul Seabright, 'Decentralizing Public Services: What Can We Learn From the Theory of the Firm?' (1996) 106 *Revue d'économie politique* 37, at 58–59.
[76] Robert P. Inman and Daniel L. Rubinfeld, 'Rethinking Federalism' (1997) 11 *The Journal of Economic Perspectives* 43, at 49
[77] Article 4.3.1 of the TEU.
[78] CJEU, Joined Cases 6 and 11/69, *Commission v France*, [1969] ECR 0523, para. 16.
[79] Article 4.3.2 of the TEU.
[80] Article 4.3.3 of the TEU.

States',[81] including NCAs. Therefore, where the implementation of EU law raises special difficulties (such as, cross-border transaction of investment conduct supervision), Member States should submit them to the Commission and work together with it in good faith with a view to overcoming the difficulties.[82] Based on the principle of sincere co-operation, MiFID I sets some obligations of co-operation between Member States.[83] However, there is little definitive guidance of these obligations,[84] and it also lacks an official mechanism to tackle disputes of co-operation. Therefore, rules of MiFID II guarantee the co-operation in cross-border situations between NCAs,[85] along with the role played by ESMA as a mediator.[86] By means of this, the current system offers enough safeguards to tackle the co-operation issues that may arise from the network-based supervision between Member States.[87] As some commentators said, '[i]nstead of a single regulatory method for financial markets, successive coordinating layers have been established [in ESMA] that do what they can to fill in the gaps.'[88]

Furthermore, two other logical cures have been discussed for the co-operation

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[81] CJEU, Case 80/86, *Kolpinghuis Nijmegen*, [1987] ECR 3969, para. 12.

[82] CJEU, Case 52/84, *Commission v Belgium*, [1989] ECR 89, para. 16; Case 94/87, *Commission v Germany*, [1989] ECR 175, para. 9; Case C-75/97, *Belgium v Commission*, [1999] ECR I-3671, para. 88; Case C-404/97, *Commission v Portugal*, [2000] ECR I-4897, para. 40; Case C-261/99, *Commission v France*, [2001] ECR I-2537, para. 24; Case C-378/98, *Commission v Belgium*, [2001] ECR I-5107, para. 31; Case C-499/99, *Commission v Spain*, [2002] ECR I-6031, para. 24; Case C-404/00, *Commission v Spain*, [2003] ECR I-6723, para. 46; Case C-457/00, *Belgium v Commission*, [2003] ECR I-6989, para. 99; Case C-278/00, *Greece v Commission*, [2004] ECR I-4085, para. 114; Case C-99/02, *Commission v Italy*, [2004] ECR I-3364, para. 17; Case C-415/03, *Commission v Greece*, [2005] ECR I-3910, para. 42; Case C-441/06, *Commission v France*, [2007] ECR I-8890, para. 28; Case C-214/07, *Commission v French Republic*. [2008] ECR I-8537, para. 45; Case C-507/08, *Commission v Slovak Republic*, [2010] ECR I-13489, para. 44; Case C-304/09, *Commission v Italian Republic*, [2010] ECR I-13903, para. 37; Case C-305/09, *Commission v Italian Republic*, [2011] ECR I-3225, para. 34.

[83] See Articles 56–62 of MiFID I.

[84] Michael Raffan, 'The Investment Services Directive and the Markets in Financial Instruments Directive' in Freshfield Bruckhaus Deringer and Michael Raffan (eds), *A Practitioner's Guide to EU Financial Services Directives* (2nd edn, City & Financial Publishing, 2006), at 167.

[85] Articles 79–87 of MiFID II.

[86] Article 19 of ESMA Regulation. See further in Section 3.2.2 of CHAPTER III (pp. 93–94).

[87] P. Schammo, above note 55, at 791–793.

[88] Shawn Donnelly, 'The Public Interest and the Economy in Europe in the Wake of the Financial Crisis' (2011) 10 *European Political Science* 384, at 391.

issue without the establishment of a supranational supervisor: first, adding more accountability and powers to home Member States' NCAs in order to stimulate them to take into account the interests of host Member States;[89] and, second, equipping more powers to host Member States' NCAs in order to protect their States' interests.[90] Indeed, if incentives are sufficiently aligned or even the conflicts of incentives are small, decentralisation is the preferred method of governance than centralisation.[91] In the light of the above discussion, any centralised supervision of investment conduct might find it hard to satisfy the test of 'cannot be sufficiently achieved' by the reason of tackling the co-operation issue solely between NCAs. In fact, even though the argument in favour of the centralised investment conduct supervision could pass the initial test of 'cannot be sufficiently achieved' within the principle of subsidiarity, it still should be further examined by a comparative institutional analysis for assessing the 'better achieved' and 'necessary to achieve' tests within the principles of subsidiarity and proportionality.

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89 See, e.g., Mads Andenas, 'Liability for Supervisors and Depositors' Rights: the BCCI and the Bank of England in the House of Lords' (2001) 22 *Company Lawyer* 226, at 234; Eddy Wymeersch, 'The Future of Financial Regulation and Supervision in Europe' (2005) 42 *Common Market Law Review* 987, at 999–1003; Sotiris I. Dempegiotis, 'The Hard-to-Drive Tandem of Immunity and Liability of Supervisory Authorities: Legal Framework and Corresponding Legal Issues' (2008) 9 *Journal of Banking Regulation* 131, at 131–149; Evelien De Kezel, 'The Liability of the Dutch Financial Supervisors in An International Perspective' (2009) 6 *European Company Law* 211, at 213–214; Larisa Dragomir, *European Prudential Banking Regulation and Supervision: The Legal Simension* (Routledge, 2010), at 301–369; Phoebus Athanassiou, 'Bank Supervisors' Liability: A European Perspective' (2011) 30 *Yearbook of European Law* 213, at 213–254; J. Dijkstra Robert, 'Liability of Financial Supervisory Authorities in the European Union' (2012) 3 *Journal of European Tort Law* 346, at 346–377.

90 See, e.g., Adair Turner, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (FSA, 2009), at 101–102; Katharina Pistor, 'Host's Dilemma: Rethinking EU Banking Regulation in Light of the Global Crisis' in Stefan Grundmann, Brigitte Haar and Hanno Merkt (eds), *Festschrift für Klaus J Hopt zum 70: Unternehmen, Markt und Verantwortung*, vol 1 (De Gruyter, 2010), at 2339–2366; Pierre Schammo, ''Home Country Control with Consent': A New Paradigm for Ensuring Trust and Cooperation in the Internal Market?' (2013) 15 *Cambridge Yearbook of European Legal Studies* 467, at 467–502.

91 Heikki Rantakari, 'Governing Adaptation' (2008) 75 *The Review of Economic Studies* 1257, at 1257–1285; Ricardo Alonso, Wouter Dessein and Niko Matouschek, 'When Does Coordination Require Centralization?' (2008) 98 *The American Economic Review* 145, at 145–179.

4. 'Better Achieved' and 'Necessary to Achieve' Tests

4.1. Comparison of Costs Incurred by Uncertainty/Complexity

As Professor Takis Tridimas said, the evolution of EU capital market regulation has been 'a journey towards federalisation'.[92] The theory of federalism for the vertical allocation of competence in a multi-level system, thus, could provide a good starting point for the institutional comparison, albeit it is derived from the competence allocation between the federal and state governments in the USA.[93] Its initial focus on public finance lays out a general normative framework for the assignment of competences to different levels of government.[94] A centralised (or unitary) government would possess a far greater capability to tackle macroeconomic stabilisation problems, but a basic shortcoming of a centralised government is its insensitivity to varying preferences.[95] Furthermore, economies of scale, as positive externalities and their limitations, might be another factor that should be considered in the decision regarding (de)centralisation.[96] Therefore, within the standard approach of the federalism theory, the heterogeneity and spillovers are at the heart of the debate about the gains from centralisation,[97] and a least-cost model of federalism is formed to find the optimum assignment of competences in a multi-level government.[98] This is in line with the

[92] Takis Tridimas, 'EU Financial Regulation: Federalization, Crisis Management, and Law Reform' in Paul Craig and Gráinne de Búrca (eds), *The Evolution of EU Law* (Oxford University Press, 2011), at 783.
[93] W. Kip Viscusi, Joseph Emmett Harrington and John M. Vernon, *Economics of Regulation and Antitrust* (4th edn, The MIT Press, 2005), at 14–19.
[94] Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice* (4th edn, McGraw-Hill, 1984), PART FIVE.
[95] Wallace E. Oates, *Fiscal Federalism* (Harcourt Brace Jovanovich, 1972), at 4–13.
[96] Gordon Tullock, 'Federalism: Problems of Scale' (1969) 6 *Public Choice* 19, at 19–29.
[97] Timothy Besley and Stephen Coate, 'Centralized versus Decentralized Provision of Local Public Goods: A Political Economy Approach' (2003) 87 *Journal of Public Economics* 2611, at 2628.
[98] Albert Breton and Anthony Scott, *The Economic Constitution of Federal States* (University of Toronto Press, 1978), Ch. 7.

standard of institutional selection applied by this thesis.[99] However, since the arguments of the federalism theory are derived from the welfare economics, an implicit assumption of it is that government agencies, which are omniscient and benevolent, would seek to maximise social welfare.[100] By comparison with the perspective of the transaction cost approach, these arguments hence could be used to tackle the issues in respect of the environmental factors merely.[101]

4.1.1. Centralisation: Negative Externalities

In the wake of the global financial crisis followed by the Eurozone debt crisis, centralisation of supervision is supported by the reason of tackling cross-border problems,[102] since the liberalisation process in the EU is not immunised from contagion effects.[103] First, Member States are unable to tackle pan-EU issues after the liberalisation, particularly limited policy options as a result of free movement.[104] Second, the free movement of capital does not avoid inconsistent developments and can even hide them, exaggerating a more serious consequence.[105] Mere harmonisation of legal frameworks through Regulations and Directives may not be enough to eliminate negative cross-border externalities caused by market integration, given the importance

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[99] See further in Section 4.1 of CHAPTER IV (pp. 169–172).

[100] Wallace E. Oates, 'Toward A Second-Generation Theory of Fiscal Federalism' (2005) 12 *Int Tax Public Finan* 349, at 350.

[101] See further in Section 3.2.1 of CHAPTER IV (pp. 153–155).

[102] Recital 37 of ESMA Regulation; Recital 5 of SSM Regulation.

[103] See, e.g., Sabur Mollah, A. M. M. Shahiduzzaman Quoreshi and Goran Zafirov, 'Equity Market Contagion During Global Financial and Eurozone Crises: Evidence from A Dynamic Correlation Analysis' (2016) 41 *Journal of International Financial Markets, Institutions and Money* 151, at 151–167; Milda Maria Burzala, 'Contagion Effects in Selected European Capital Markets During the Financial Crisis of 2007–2009' (2016) 37 *Research in International Business and Finance* 556, at 556–571.

[104] Till Hafner, 'The Free Movement of Capital in the European Union' in Rainer Grote and Thilo Marauhn (eds), *The Regulation of International Financial Markets: Perspectives for Reform* (Cambridge University Press, 2006), at 142.

[105] Mario Sarcinelli, 'The European Banking Union: Will It Be a True Union without Risk Sharing?' (2013) 66 *PSL Quarterly Review* 137, at 139–141.

of judgment in supervisory decisions.[106] According to Article 3.3 of the TEU, the EU 'shall promote economic, social and territorial cohesion, and solidarity among Member States', so how to make sure a structure of supervision does not lead to fragmentation of the single market is the real issue of the EU.[107]

A financial trilemma is modelled to clarify this issue, stating that: (i) financial stability, (ii) financial integration, and (iii) national financial supervision are incompatible; and, if any two of these three objectives can be combined, one has to be given up thereafter.[108] Indeed, policymakers can solve the financial trilemma by breaking connections of the integrated market.[109] But, if the trend of stable integration in the EU is irreversible, the establishment of pan-European supervisors is needed to tackle the issues caused by the integration.[110] Supranational bodies can take supranational actions and exercise controls over national supervisors legitimately,[111] so they have the ability to

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[106] Martin F. Hellwig, *Yes Virginia, There is a European Banking Union! But it May Not Make Your Wishes Come True* (MPI Collective Goods Preprint, No 2014/12, 2014), at 13; Mads Andenas, 'Harmonising and Regulating Financial Markets' in Mads Andenas and Camilla Baasch Andersen (eds), *Theory and Practice of Harmonisation* (Edward Elgar Publishing, 2012), at 12–25. See further in Section 4.2 of CHAPTER II (pp. 65–68).

[107] Mario Monti, *A New Strategy for the Single Market-At the Service of Europe's Economy and Society* (Report to the President of the European Commission 2010), at 64, available at: <http://ec.europa.eu/internal_market/strategy/docs/monti_report_final_10_05_2010_en.pdf> (accessed June, 2017).

[108] Dirk Schoenmaker, 'Resolving the Stability Trilemma' (2008) 13 *Financial Regulator* 45, at 46; for further details of this model: see Dirk Schoenmaker, 'The Financial Trilemma' (2011) 111 *Economics Letters* 57, at 57–59. It should be noted that Scherf also modelled another trilemma in banking regulation, showing that (i) financial stability; (ii) credit access; and (iii) bank competitiveness cannot be all attained at the same time. However, this trilemma is not the focus of this study. See Gundbert Scherf, *Financial Stability Policy in the Euro Zone: The Political Economy of National Banking Regulation in an Integrating Monetary Union* (Springer Gabler, 2014), at 80–87.

[109] Caroline Bradley, 'Breaking up Is Hard to Do: The Interconnection Problem in Financial Markets and Financial Regulation, a European (Banking) Union Perspective' (2014) 49 *Texas International Law Journal* 271, at 274.

[110] Dirk Schoenmaker and Sander Oosterloo, 'Financial Supervision in Europe: A Proposal for a New Architecture' in Lars Jonung (ed), *Building the Financial Foundations of the Euro: Experiences and Challenges* (Routledge, 2008), at 336–344.

[111] IMF, *The IMF's Financial Surveillance Strategy* (IMF Policy, 2012), at 4.

address transnational issues in ways which are difficult for national supervisors.[112] SSM was a clear example born out of the realisation of this 'dark side' of market integration.[113] Without doubt, NCAs will lose part of their powers in favour of a supranational body and countries will renounce part of their sovereignty, but this is the price to pay for 'stable' market integration.[114]

4.1.2. Centralisation: Economies of Scale

Thanks to the effect of economies of scale, the smaller number of supervisors, the lower monitoring costs: centralised supervision can allocate its resources in a more efficient way than multiple supervisors.[115] This advantage can be found in many specific ways. First, centralised supervision is a solution to the overlapping competences of the current supervisory system, in which monitoring costs might be paid double by home and host Member States.[116] Second, centralised supervision is a supranational cure to reduce costs for negotiation and co-operation between NCAs.[117] Third, centralisation of supervision could potentially reduce the high costs of prosecuting EU law caused by different institutional capacities of Member States.[118] Finally, for non-EU supervisors, facing a single market European supervisor would obviously facilitate discussion and

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112 Ibid, at 12.
113 E. Ferran, 'European Banking Union: Imperfect, But It Can Work', above note 62, at 25.
114 Guido Ferrarini and Luigi Chiarella, *Common Banking Supervision in the Eurozone: Strengths and Weaknesses* (ECGI Law Working Paper No 223/2013, 2013), at 11.
115 Y. Avgerinos, above note 9, at 149. For an empirical analysis: see Martin Schüler and Friedrich Heinemann, *The Costs of Supervisory Fragmentation in Europe* (ZEW Discussion Paper No 05-01, 2005), at 1–14.
116 See further in Section 2 of CHAPTER III (pp. 75–85).
117 Donato Masciandaro and Maria Nieto, *Governance of the Single Supervisory Mechanism: Some Reflections* (Baffi Center Research Paper No 2014-149, 2014), at 3. See further in Section 4.3.2 of CHAPTER III (pp. 125–128).
118 Kern Alexander, 'Reforming European Financial Supervision and the Role of EU Institutions' (2010) 82 *Amicus Curiae* 2, at 10; Kern Alexander, *Which Future Model for Europe?* (European Parliament's Special Committee on the Financial, Economic and Social Crisis, IP/A/CRIS/IC/2010-025, 2010), at 14–15. See further in Section 4.3.1 of CHAPTER III (pp. 123–125).

worldwide co-operation of supervision surrounding the international financial markets, because they can 'speak with one voice'.[119] The EU's whole interest could be asserted at the global level by this single supervisor, especially as not all NCAs of Member States are members of international standard setters.[120]

Besides the benefits to supervisors, supervisees and markets can also gain significant benefits from centralisation. This is because 'when two nations unite, average trading costs are reduced since some international transactions now become domestic transactions',[121] centralised supervision could have beneficial effects for harmonisation and integration.[122] Specifically, from the viewpoint of investment firms, after building a pan-European supervisor with overall responsibility of supervision, a 'level playing field' will be produced by uniform approaches for supervision.[123] As a result of this legal certainty, regulated investment firms no longer need to comply with duplicated supervision of both home and host Member States, followed by a reduction of substantial compliance costs.[124] From the viewpoint of capital markets, centralised supervision in charge of information system helps capital markets reducing information costs. This is because: first, the multiplicity of reporting systems on regulated investment firms restricts the markets' ability to achieve efficiency in disclosure due to

[119] Stéphane Janin, 'Financial Services: A Long Way Towards A Single European Regulator?' (2008) 1 *Journal of Securities Law, Regulation & Compliance* 370, at 375.
[120] See further in Stephen Woolcock, *European Union Economic Diplomacy: The Role of the EU in External Economic Relations* (Routledge, 2012), Figure 4.3 of page 101.
[121] Patrick Bolton, Gérard Roland and Enrico Spolaore, 'Economic Theories of the Break-up and Integration of Nations' (1996) 40 *European Economic Review* 697, at 700.
[122] Valia S.G. Babis, *Single Rulebook for Prudential Regulation of Banks: Mission Accomplished?* (University of Cambridge Faculty of Law Research Paper No 37/2014, 2014), at 37.
[123] Roel Beetsma and Sylvester Eijffinger, 'The Restructuring of Financial Supervision in the EU' (2009) 8 *European View* 3, at 9.
[124] Yannis Avgerinos, *EU Financial Market Supervision Revisited: The European Securities Regulator* (Jean Monnet Working Paper 7/03, 2003), at 26.

the significant costs caused the multiplicity;[125] and, second, if information is required to be disclosed by disparate means, information asymmetries of the markets may not be redressed because investors may find it is too inconvenient and difficult to retrieve the information.[126] A recent study shows that it costs an average investor €430 per month to obtain a full real-time picture of equity prices in the EU, while the same service costs an American investor €58.[127] Therefore, centralised supervision may reduce significant information costs, bringing further integration of the EU capital markets.[128]

4.1.3. Decentralisation: Heterogeneity of Preferences

Nonetheless, the benefits of the economies of scale are not unlimited. As some said, 'it [centralisation] must be carefully applied and must not be in any way interpreted as a possibility or a potential danger of "levelling" the Member-States of the Union, by excessively reducing or erasing national differences.'[129] Extremely centralised supervision may cause considerably higher costs on the huge EU market than local supervision. A supervisory legwork may need to be performed 'close to the ground', in order to save NCAs' knowledge of national, regional and local banking markets, their longstanding expertise and their advantages with regard to location and language skills.[130]

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125 Forum_Group, *Reporting Requirements* (Findings of the Forum Group n°10, Final Synthesis Report, 2002), Sec. B.

126 Iris H-Y Chiu, 'Delegated Regulatory Administration in Mandatory Disclosure - Some Observations from EU Securities Regulations' (2006) 40 *International Lawyer* 737, at 762–763.

127 Oxera, *Pricing of Market Data Services: An economic analysis* (Oxera Report, 2014), at 34, available at: <http://www.oxera.com/getattachment/33e57fa3-73c0-4462-9824-81f2bd0c77ca/Oxera-report-on-market-data.pdf.aspx?ext=.pdf> (accessed June, 2017).

128 R. S. Karmel, above note 7, at 35.

129 Oprea Florin, 'Fiscal Federalism and Fiscal Decentralization in An Enlarged European Union' (2010) 1 *Annals of Faculty of Economics* 623, at 628.

130 Tobias H. Tröger, 'The Single Supervisory Mechanism – Panacea or Quack Banking Regulation? Preliminary Assessment of the New Regime for the Prudential Supervision of Banks with ECB Involvement' (2014) 15 *European Business Organization Law Review* 449, at 470–471.

By contrast to centralisation supervision, decentralised supervision can accommodate supervisory proximity to the markets, in which risks reflect investment patterns, product features and distribution structures that relate to particular characteristics of domestic markets.[131] As admitted by the European Court of Human Rights ('ECtHR'): '[b]ecause of their direct knowledge of their society and its needs, the national authorities are in principle better placed than the international judge to appreciate what is "in the public interest"'.[132] Due to their knowledge of the local markets, local supervision will remain the best solution in many places of supervision (such as, direct contact with the supervised entities).[133] It is undeniable that NCAs are better placed than a European supervisor to monitor market developments,[134] and they could take some good decisions on financial issues.[135] Likewise, when citizens' tastes vary with geography, there will often be efficiency gains from differentiating policies for matching citizens' preferences.[136] Extreme centralisation might 'penalise' small operators and less developed Member States.[137] For example, small firms, some financial services providers and non-financial firms have been disproportionately affected by capital requirements, along with the dangers of a lack of proportionality.[138]

131 Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge University Press, 2010), at 430.
132 ECtHR, *James and others v the United Kingdom*, no. 8793/79, 21 February 1986, Series A no. 98, para. 46; *Grainger and others v the United Kingdom*, no. 34940/10, 10 July 2012, ECHR 2012, para. 36.
133 Myriam Senn, 'Decentralisation of Economic Law—An Oxymoron?' (2005) 5 *Journal of Corporate Law Studies* 427, at 444; Eddy Wymeersch, 'The European Financial Supervisory Authorities or ESAs' in Eddy Wymeersch, Klaus J. Hopt and Guido Ferrarini (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (Oxford University Press, 2012), at 317.
134 Recital 48 of MiFIR.
135 Andra Florian, 'Brief Considerations regarding the Establishment of a Banking Union in the European Union' (2013) 1 *Studia Universitatis Babes-Bolyai Jurisprudentia* 161, at 166.
136 Daniel Treisman, *The Architecture of Government: Rethinking Political Decentralization* (Cambridge University Press, 2007), at 59–62.
137 Karel Lannoo, *European Financial System Governance* (CEPS Policy Brief No106, 2006), at 6.
138 European Union Committee of House of Lords, The Post-Crisis EU Financial Regulatory Framework:

Given that NCAs have important and long-established expertise in the supervision within their territory and their economic, organisational and cultural specificities,[139] it is doubtful that a Europe-wide regime is capable of addressing the vagaries of all of the EU national markets.[140]

As F. A. Hayek, the 1974 Nobel Prize winner in Economic Sciences, said: '[w]e must solve it [the knowledge issue] by some form of decentralisation'.[141] This argument is also support by the preamble and Article 1.2 of the TEU: the decisions should be made 'as closely as possible to the citizen' in order to create an ever closer union among the peoples of Europe. However, it should be admitted that decentralisation, inevitably, comes together with some additional costs for aligning the different interests of the EU and Member States. There is always a trade-off between centralisation and decentralisation. But, the potential gains of a decentralised system, such as, lesser collecting costs of local information and better understanding of local demands, always have some explanation in favour of the argument of decentralisation.[142]

4.1.4. Increased Costs after Centralised Investment Conduct Supervision

As the decentralisation theorem under the federalism theory highlights:

Do the Pieces Fit?, HL Paper 103, February, 2015, para. 164, available at: <http://www.publications.parliament.uk/pa/ld201415/ldselect/ldeucom/103/103.pdf> (accessed June, 2017).
See also European Commission, Summary of contributions to the 'Call for Evidence: EU Regulatory Framework for Financial Services', at 12–13, available at: <http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/docs/summary-of-responses_en.pdf> (accessed June, 2017).

[139] Recital 37 of SSM Regulation.

[140] Iulian Panait, 'Towards the Capital Market Union' (2015) 2 *Hyperion Economic Journal* 38, at 42; Niamh Moloney, 'Financial Market Governance and Consumer Protection in the EU' in Ester Faia et al (eds), *Financial Regulation: A Transatlantic Perspective* (Cambridge University Press, 2015), at 235.
See also Letter from Joint Associations Committee to European Commission, January, 2008, at 3, available at: <http://www.isda.org/whatsnew/pdf/080118-JAC-Call_response.pdf> (accessed June, 2017).

[141] F. A. Hayek, 'The Use of Knowledge in Society' (1945) 35 *American Economic Review* 519, at 524.

[142] W. E. Oates, 'An Easy on Fiscal Federalism', above note 45, at 1123.

> 'in the absence of cost-savings from the centralised provision of a good and of interjurisdictional external effects, the level of welfare will always be as least as high (and typically higher) […] in each jurisdiction than […] any single, uniform level of […] maintained across all jurisdictions.'[143]

This is the partial case of investment conduct supervision in the EU, because, at the present stage, investment conduct supervision has only limited cross-border activities[144]—'EU investors' do not exist, for the moment at least.[145] Even if cross-border problems happen, investment conduct supervision, which normally pays attention to the 'micro' issue regarding relationships between investment firms and their clients (namely, investor protection), would be lower in priority than other 'macro' issues (such as, financial stability).[146] Thus, the argument for centralisation, based on negative externalities, would not be compelling here, and investment conduct supervision cannot be seen as a convincing case for centralisation at the EU level due to this reason.[147] The decision as to (de)centralised investment conduct supervision, principally, needs to take account of the positive externalities and the heterogeneity of preferences. Given the optimum level of investment conduct supervision in the EU is formed by a trade-off between the economies of scale and the heterogeneity of

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143 W. E. Oates, above note 95, at 54.

144 For further relative empirical evidence: see European Commission, Retail Financial Services Report, Special Eurobarometer 373, March, 2012, available at: <http://ec.europa.eu/internal_market/finservices-retail/docs/policy/eb_special_373-report_en.pdf> (accessed June, 2017).

145 N. Moloney, *How to Protect Investors: Lessons from the EC and the UK*, above note 131, at 31.

146 Jeroen JM Kremers and Dirk Schoenmaker, *Twin Peaks: Experiences in the Netherlands* (LSE Financial Markets Group Paper Series Special Paper 196, 2010), at 4–5.

147 Veerle Colaert, 'European Banking, Securities, and Insurance Law: Cutting through Sectoral Lines?' (2015) 52 *Common Market Law Review* 1579, at 1610; Niamh Moloney, 'Capital Markets Union: "Ever Closer Union" for the EU Financial System?' (2016) 41 *European Law Review* 307, at 399.

preferences, it would not be in the extreme extent of centralisation.[148]

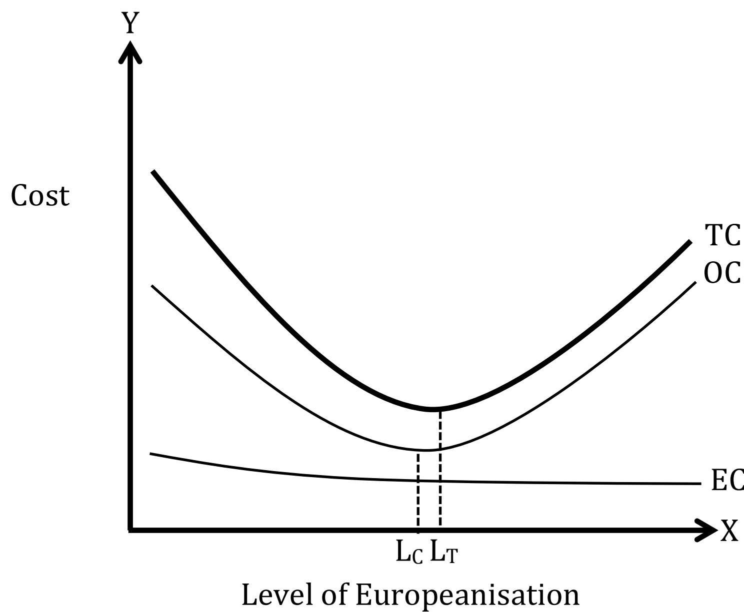

Figure VI-1: Comparison of Costs Incurred by Uncertainty/Complexity between Centralisation and Decentralisation in the EU

In brief, based on the federalism theory, a comparison between the current system and the centralised supervision in the field of investment conduct could be explained by foregoing Figure VI-1. The X-axis and Y-axis represent the number of transaction costs and the level of Europeanisation respectively. First of all, the EC line shows external costs caused by the negative externalities, and it slopes trivially to the right and levels thereafter. Negative externalities, hence, are not decisive factors in the consideration of the terms of the centralised supervision of investment conduct. Second, organisational costs, as the OC line shows, decrease gradually due to the economies of scale, and this trend reverses after reaching the lowest point ('L_C') due to the heterogeneity of preferences. Because the 'preference asymmetries' in investment conduct supervision, the same as in the field of justice and consumer protection, is still very large between

[148] Alberto Alesina and Enrico Spolaore, *The Size of Nations* (The MIT Press, 2003), Ch. 12.

Member States,[149] the level of L_C point (namely, the level of Europeanisation) would not be high due to the high heterogeneity of preferences. Given the optimum level of governance is at the point of lowest total transaction costs, the TC line, which represents the sum of the external costs and organisational costs, reveals the optimum level of Europeanisation is at point L_T. Any level of Europeanisation of investment conduct supervision higher than point L_T would not have lower total transaction costs, so, at the current stage, the establishment of a single supervisor in charge of investment conduct supervision in the EU may not be supported. However, it is noteworthy that if either: (i) the slope of the EC line becomes significant (namely, higher negative externalities), or (ii) the lowest point of the OC line moves to the right (namely, higher economies of scale or lower heterogeneity of preferences), the optimum level of Europeanisation will get higher and point L_T will be more 'right' towards centralisation.

4.2. Comparison of Costs Incurred by Small Numbers

Even the aforementioned 'mainline' federalism theory provides some strong arguments for the competence assignment in a multi-level government, it rules out the issue of inter-governmental competition.[150] After answering the question of 'why centralise' in the previous section, it is the time to ask 'why decentralise' in turn? If there is no significant negative externalities here, Tiebout's model,[151] with respect to the theory of inter-governmental competition, could be applied in support of

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149 Alberto Alesina, Ignazio Angeloni and Ludger Schuknecht, 'What Does the European Union Do?' (2005) 123 *Public Choice* 275, at 283–284

150 Albert Breton, *Competitive Governments: An Economic Theory of Politics and Public Finance* (Cambridge University Press, 1998), at 201–203.

151 Charles M. Tiebout, 'A Pure Theory of Local Expenditures' (1956) 64 *Journal of Political Economy* 416, at 419–420.

decentralisation: under certain circumstances, competition between jurisdictions supplying rival combinations of local public goods would lead to an efficient supply of such goods.[152] Whilst this model has been highly criticised due to its restrictive conditions,[153] it is a pioneering contribution to the theory of regulatory competition.[154] Tiebout's model has found some support, asserting that competition between governments would produce optimal legal rules with respect to corporate charters.[155] In fact, the regulatory competition theory is elaborated from the heterogeneity of preferences aforementioned,[156] along with a more systematic and detailed analysis of decentralisation.[157] Here, the issue of small numbers in regulation[158] is taken into account in the theory of 'supervisory' competition.

4.2.1. Decentralisation: Competition to Efficiency

Although rich literature of the regulatory competition exists in the field of rule-making process in the EU,[159] there is a missing link of allocation of supervisory competences.[160] It is, thus, needed to examine the force of supervisory competition by incorporating relative arguments. First, Tiebout's model focuses on the mobility of

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152 Robert P. Inman and Daniel L. Rubinfeld, 'The Political Economy of Federalism' in Dennis C. Mueller (ed), *Perspectives on Public Choice: A Handbook* (Cambridge University Press, 1996), at 83–86.
153 See, e.g., Pierre Pestieau, 'The Optimality Limits of the Tiebout Model' in Wallace E. Oates (ed), *The Political Economy of Fiscal Federalism* (Lexington Books, 1977), at 173–186; Truman F. Bewley, 'A Critique of Tiebout's Theory of Local Public Expenditures' (1981) 49 *Econometrica* 713, at 713–736.
154 See further in Section 2.2 of CHAPTER II (pp. 20–22).
155 See, e.g., Ralph K. Winter, Jr., 'State Law, Shareholder Protection, and the Theory of the Corporation' (1977) 6 *The Journal of Legal Studies* 251, at 251–292; Daniel R. Fischel, 'The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law' (1982) 76 *Northwestern University Law Review* 913, at 913–945; Roberta Romano, 'Law as a Product: Some Pieces of the Incorporation Puzzle' (1985) 1 *Journal of Law, Economics, and Organization* 225, at 225–284.
156 See Section 4.1.3 above (pp. 280–282).
157 W. E. Oates, 'Toward A Second-Generation Theory of Fiscal Federalism', above note 100, at 354.
158 See Section 3.2.1 of CHAPTER IV (pp. 154–155).
159 See further in Section 2.2 of CHAPTER II (pp. 20–22).
160 Josephine van Zeben, *Regulatory Competence Allocation: The Missing Link in Theories of Federalism* (ACLE Working Paper, 2013), part II.

supervisees as a stimulation of intergovernmental competition.[161] Given the implicit assumption is that supervisory authorities would seek to maximise social welfare of their own countries, countries below optimum size will seek to attract new supervisees, whereas those above optimum size will try to turn away extant supervisees.[162] In this sense, divergent supervision of investment conduct in Member States is for the purpose of (dis)attracting investment firms. This supervisory competition would result in an efficient outcome of each Member State.

Second, even in the absence of mobility of supervisees, supervisory competition can still take place across jurisdictions through the channel of capital mobility and this is often the case in capital markets.[163] Given this, NCAs of investment conduct supervision in Member States may (dis)attract foreign capitals by means of adjusting their standard of supervision until they achieve the maximised social welfare. Third, where there is no mobility of capitals between different Member States, the 'yardstick competition' may still happen: namely, supervisory competition takes place merely through the free flow of information.[164] Based on this, if citizens of a jurisdiction use information in other jurisdictions as a benchmark to evaluate the performance of their supervisory authorities, the supervisory authorities will compete with others.[165] Therefore, by means of these three types of supervisory competition, investors and

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[161] This is the first condition of the Tiebout's model: see C. M. Tiebout, above note 151, at 419.

[162] This is the seventh condition of the Tiebout's model: see ibid, at 419.

[163] Barbara Gabor, *Regulatory Competition in the Internal Market Comparing Models for Corporate Law, Securities Law and Competition Law* (Edward Elgar, 2013), at 15–16.

[164] Jeffrey L. Harrison, 'Yardstick Competition: A Prematurely Discarded Form of Regulatory Relief' (1979) 53 *Tulane Law Review* 465, at 467.

[165] Pierre Salmon, 'Decentralisation as An Inventive Scheme' (1987) 3 *Oxford Review of Economic Policy* 24, at 30–32; Timothy Besley and Anne Case, 'Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition' (1995) 85 *The American Economic Review* 25, at 25–45.

investment firms in each Member State may compare other Member States' investment conduct supervision, and then enforce NCAs to meet the optimum outcome in their territories.

4.2.2. Increased Costs after Centralised Investment Conduct Supervision

Based on the supervisory competition theory, centralised supervision of investment conduct in the EU will bring increased costs. This is because the distinction between Member States with regard to the supervisory preferences is significant: some are characterized by heavy public intervention in markets, but a more 'laissez-faire' attitude is featured in others.[166] If we assume that Member State A and Member State B have their own TC lines respectively (i.e., TC_A and TC_B) in Figure VI-2 below, each Member State would seek to achieve the lowest costs responding to the optimum level of Europeanisation, as discussed above.[167] Therefore, Member State A would like to stop at the level of L_A with total transaction costs of C_{A1}. If Member State A goes further to the level L_B, its total transaction costs would increase again to C_{A2}. By comparison, Member State B would like to continue centralising until it reaches the level of L_B. This is because Member State B can reduce more transaction costs ($C_{B1}-C_{B2}$) by enhancing the level L_A to L_B. There is no need to require Member States to do so, because they would try to find their lowest-cost level of Europeanisation automatically.

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[166] Alberto Alesina and Roberto Perotti, 'The European Union: A Politically Incorrect View' (2004) 18 *The Journal of Economic Perspectives* 27, at 33–34.
[167] See Section 4.1.4 above (pp. 284–285).

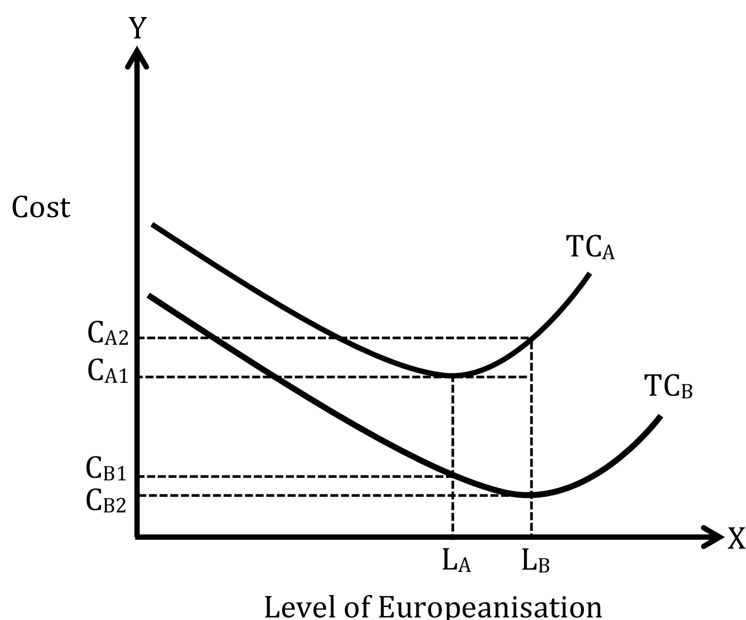

Figure VI-2: Comparison of Costs Incurred by Small Numbers between Centralisation and Decentralisation in the EU

Given the aforementioned assumption, in order to enhance the level of Europeanisation, Member State B would choose to convey some benefits from which it will gain by this enhancement to Member State A. Therefore, as a compromise resulting from supervisory competition, the co-operation between Member States A and B would only be possible to locate at the level between L_A and L_B.[168] Furthermore, if the discrepancy between the level L_A and the level L_B is huge, this compromise would be extremely difficult to reach. This is because it is hard to find a balanced point between: (i) the decreasing costs of Member State B, and (ii) the increasing costs of Member State A caused by higher Europeanisation. In this sense, from the normative viewpoint, a single supervisor in charge of investment conduct supervision, which obviously represents a higher level of Europeanisation than the levels L_B, would not be a comparatively better governance choice than the *status quo*. The proposed single

168 See further in Patrick Bolton and Gerard Roland, 'The Breakup of Nations: A Political Economy Analysis' (1997) 112 *The Quarterly Journal of Economics* 1057, at 1066–1072.

supervisor, from the positive viewpoint, would also be unfeasibly achieved through negotiations between Member States. Nevertheless, it should be further highlighted that if either L_A or L_B moves to the right more, the compromised point would also move to the right more. This movement towards higher level of Europenisation may be caused by changes of the TC line, as discussed above.[169]

In stark contrast to the benefits of supervisory competition, the 'race to the bottom' argument could not be ignored, and it indeed raises a heated debate in the EU. It provides a strong counter-argument: an efficient equilibrium of supervisory competition does not exist since this competition will also encounter the market's malfunctions.[170] Even if 'there is a market for regulation or rules, there is no reason to assume that this will be as perfect market'.[171] This explains the necessity of harmonisation to set up a 'bottom line' of supervisory competition in the EU.[172] Furthermore, governmental failures highlight that the outcome of supervisory competition in the European capital markets has no uniform answer.[173] The assumption of 'omniscient and benevolent' supervisors may not be held as pointed out by the transaction cost approach,[174] so the foregoing analysis is not the full story of the examination of Treaty principles. Given that '[i]nstitutions are simultaneously both objective structures "out there" and subjective springs of human agency "in the human

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169 See Section 4.1.4 above (p. 285).

170 Hans-Werner Sinn, 'The Selection Principle and Market Failure in Systems Competition' (1997) 66 *Journal of Public Economics* 247, at 247–274; Hans-Werner Sinn, *The New Systems Competition* (Blackwell, 2003), at 5–8.

171 Stephen Woolcock, 'Competition among Rules in the Single European Market' in William Bratton et al (eds), *International Regulatory Competition and Coordination: Perspectives on Economic Regulation in Europe and the United States* (Clarendon Press, 1997), at 302.

172 See further in Section 2.2 of CHAPTER II (pp. 20–22).

173 Lars Hornuf, *Regulatory Competition in European Corporate and Capital Market Law: An Empirical Aanalysis* (Intersentia, 2012), at 3–5; B. Gabor, above note 163, at 4–5.

174 See further in Sections 3.2.2 and 3.2.3 of CHAPTER IV (pp. 155–159).

head'",[175] a subjective approach, which focuses on the human factors within the organisational failures framework in the TCE, can be a good complement for the objective approach in understanding transaction costs.[176]

4.3. Comparison of Costs Incurred by Opportunism

Based on the theory of public choice, the influence of governmental/third party opportunism can be confidently asserted.[177] This challenges the efficiency of the theory of regulatory competition abovementioned.[178] After removing the assumption of benevolence, the self-interested pattern of regulators and interest groups are taken into consideration by the concept of federalism respectively[179]—the so-called 'second generation theory of federalism'.[180] This political economy perspective can provide further understanding of 'semi-benevolent' or even 'malevolent' governments in the federalism theory, but no definitive conclusion can be drawn regarding opportunism and the centralisation-decentralisation nexus.[181] The optimum level of supervision varies in different conditions.

4.3.1. Decentralisation/Centralisation: Public Choice Theory

On the one hand, a large body of literature argues that decentralised government, along with the policy competition, can limit the capacities of a monopolist (in this case a 'Leviathan') seeking its own aggrandisement through maximising the revenues it extracts

175 Geoffrey M. Hodgson, 'What Are Institutions?' (2006) 40 *Journal of Economic Issues* 1, at 8.
176 Fu-Lai Tony Yu, 'Subjectivism, Understanding and Transaction Costs' in Peter G. Klein and Michael E. Sykuta (eds), *The Elgar Companion to Transaction Cost Economics* (Edward Elgar, 2010), at 274–276.
177 See further in Section 3.2.2 of CHAPTER IV (pp. 155–157).
178 See Section 4.2.1 above (pp. 286–288).
179 J. Pelkmans, *Testing for Subsidiarity*, above note 42, at 25–27.
180 Yingyi Qian and Barry R. Weingast, 'Federalism as a Commitment to Perserving Market Incentives' (1997) 11 *The Journal of Economic Perspectives* 83, at 84; W. E. Oates, 'Toward A Second-Generation Theory of Fiscal Federalism', above note 100, at 365.
181 Ben Lockwood, 'The Political Economy of Decentralisation' in Ehtisham Ahmad and Giorgio Brosio (eds), *Handbook of Fiscal Federalism* (Edward Elgar, 2006), at 50–51.

from the economy.[182] A model based on the principal/agent approach further indicates a trade-off between centralisation and local accountability.[183] This is because decentralisation can 'force governments to represent citizen interests and to preserve markets'.[184] Some empirical research also supports the view that an increase in the number of competing jurisdictions would lead to a lower level of corruption.[185] In this sense, decentralisation can reduce the costs caused by opportunism.

On the other hand, some empirical evidence indicates a possibility of 'overgrazing': namely, competition of governments may lead to more corruption since different governments can extract bribes from the same economic actors.[186] The function of decentralisation for preventing corruption does not always work. Since corruption is often stimulated by the fact that officials and citizens live and work close to one another in local communities, decentralised governments in close contact with citizens may breed corruption.[187] Local politicians and bureaucrats are more likely to be subject to pressing demands from local interest groups.[188] Also, due to the greater cohesiveness of interest groups and higher levels of voter ignorance: the lower level of government is,

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182 See, e.g., Geoffrey Brennan and James M Buchanan, *The Power to Tax: Analytical Foundations of A Fiscal Constitution* (Cambridge University Press, 1980), at 184; Andrei Shleifer and Robert W. Vishny, 'Corruption' (1993) 108 *The Quarterly Journal of Economics* 599, at 599–617; Barry R. Weingast, 'The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development' (1995) 11 *Journal of Law, Economics, & Organization* 1, at 6; Jeremy Edwards and Michael Keen, 'Tax competition and Leviathan' (1996) 40 *European Economic Review* 113, at 113–134.

183 Paul Seabright, 'Accountability and Decentralisation in Government: An Incomplete Contracts Model' (1996) 40 *European Economic Review* 61, at 61–89.

184 Y. Qian and B. R. Weingast, above note 180, at 88.

185 Raymond Fisman and Roberta Gatti, 'Decentralization and Corruption: Evidence Across Countries' (2002) 83 *Journal of Public Economics* 325, at 325–345; G. Gulsun Arikan, 'Fiscal Decentralization: A Remedy for Corruption?' (2004) 11 *Int Tax Public Finan* 175, at 175–195.

186 Daniel Treisman, 'The Causes of Corruption: A Cross-National study' (2000) 76 *Journal of Public Economics* 399, at 430–433.

187 Vito Tanzi, 'Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects' in Michael Bruno and Boris Pleskovic (eds), *Annual World Bank Conference on Development Economics 1995* (The World Bank, 1996), at 301.

188 Rémy Prud'homme, 'The Dangers of Decentralization' (1995) 10 *The World Bank Research Observer* 201, at 211.

the greater probability of capture by local interest groups is.[189] By contrast, centralisation can result in the 'preference dilution effect', which means each lobby has smaller impact on decisions making given the increasing heterogeneity of preferences.[190] In this regard, the costs of opportunism would be reduced by centralisation.

4.3.2. Increased Costs after Centralised Investment Conduct Supervision

Overall, the effect of centralisation on lobbying might be ambiguous,[191] but it cannot be ignored in the EU. For example, as of December, 2016, there were about 11,000 registered lobbyists in the Parliament.[192] According to an unofficial study given by Corporate Europe Observatory (a non-profit organisation devoted to research and advocacy of transparent lobbying) in 2011, it was estimated that between 15,000 and 30,000 lobbyists were targeting EU decision-makers in Brussels.[193] With regard to financial market supervision in the EU, some argue that lobbying at the EU level is not as great a problem as at the national level.[194] This is because, compared to the national level, the 'capture' at the EU level instead needs stronger leverage in the dealings with a single supervisor.[195] In the contrast, some argue that concentrating supervisory powers

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189 Pranab Bardhan and Dilip Mookherjee, 'Capture and Governance at Local and National Levels' (2000) 90 *The American Economic Review* 135, at 135–139.

190 Jaime de Melo, Arvind Panagariya and Dani Rodrik, 'The New Regionalism: A Country Perspective' in Jaime De Melo and Arvind Panagariya (eds), *New Dimensions in Regional Integration* (Cambridge University Press, 1993), at 176–188.

191 Michela Redoano, 'Does Centralization Affect the Number and Size of Lobbies?' (2010) 12 *Journal of Public Economic Theory* 407, at 407–435.

192 See further in the database of the transparency register in the EU, available at: <http://ec.europa.eu/transparencyregister/public/homePage.do?redir=false&locale=en> (accessed June, 2017).

193 Corporate Europe Observatory, Lobby Planet Brussels – the EU quarter (4th edn, 2011), at 3, available at: <https://corporateeurope.org/sites/default/files/publications/ceolobbylow.pdf> (accessed June, 2017).

194 Mads Andenas, 'Who is Going to Supervise Europe's Financial Markets' in Mads Andenas and Yannis Avgerinos (eds), *Financial Markets in Europe: Towards a Single Regulator* (New York: Kluwer Law International, 2003), at xxv.

195 Sarkis Joseph Khoury and Clas Wihlborg, *Institutional Competition as an Alternative Mechanism for Harmonization in Monetary and Banking Unions* (SSRN Working Papers, 2014), at 31.

in the hands of a single supervisor may make that supervisor more prone to being 'captured', and the threat of supervisory capture can be reduced by the allocation of supervisory powers between supervisors.[196] In order to apply the anti-/pro- arguments of centralisation in the field of investment conduct supervision, the costs caused by opportunism can be viewed as two possibilities in Figure VI-3 below.

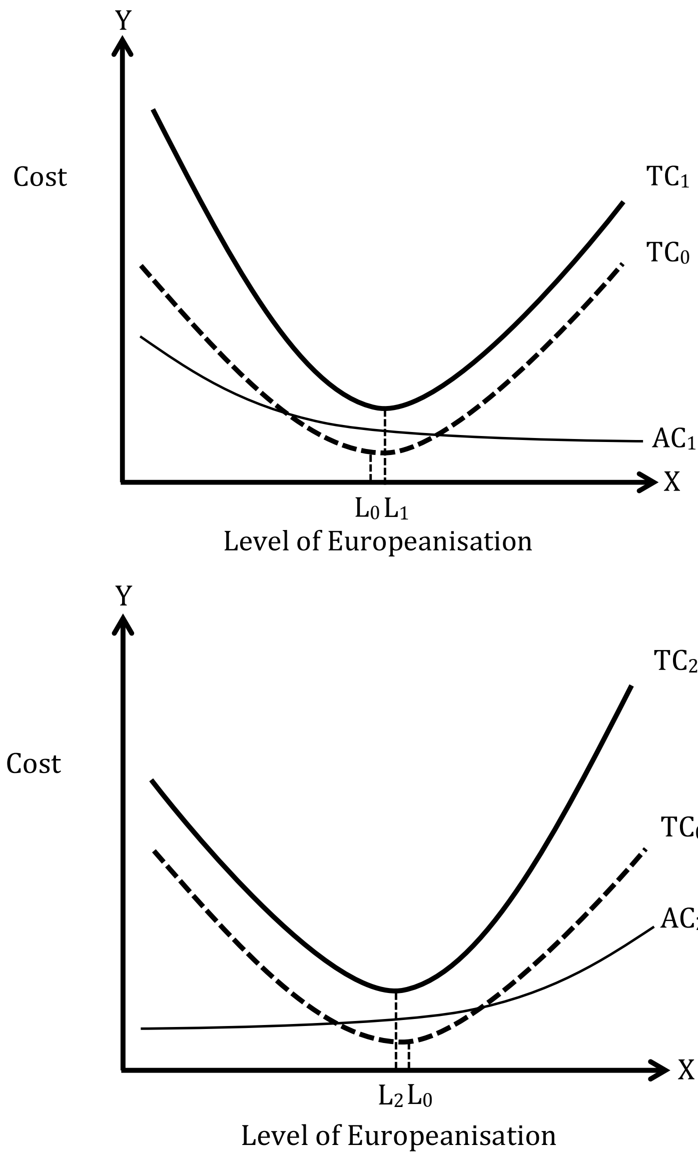

Figure VI-3: Comparison of Costs Incurred by Opportunism between Centralisation and Decentralisation in the EU

[196] Pierre C. Boyer and Jorge Ponce, 'Regulatory Capture and Banking Supervision Reform' (2012) 8 *Journal of Financial Stability* 206, at 206–217.

As mentioned above,[197] the TC line of supervision is initially set as the TC_0 line, along with the optimum level of Europeanisation at point L_0. However, since supervisors are self-interested, and supervision is influenced by interest groups, accountability costs, such as, monitoring behaviour and aligning interests, need to be added to achieve the optimum outcome. According to the second generation theory of federalism,[198] these costs might either increase or decrease with higher Europeanisation. Trends of accountability costs, thus, might be drawn as either the AC_1 or AC_2 lines. The decreasing/increasing trend would adjust the TC_0 line to be the TC_1/TC_2 line in order to maintain the benevolence of supervisors, followed by the new optimum point (L_1/L_2) towards higher/lower Europeanisation.

Given the above two possibilities assumed (namely, the TC_1 and TC_2 lines), the next step is to examine the case of investment conduct supervision in the EU would be which possibility. A useful argument indicates that the impact of centralisation or decentralisation on the efficacy of lobbies depends on whether the objectives of domestic and foreign interest groups are aligned or not.[199] When the interests of domestic lobbies are in conflict with foreign lobbies, centralisation is better than decentralisation, as the TC_1 line reveals. And *vice versa*, if interests coincide, decentralisation is suggested since centralisation means that foreign lobbies obtain a single channel to influence domestic and central governments, as the TC_2 line shows. This argument is supported by some empirical evidence and particularly in fields, such

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197 See Section 4.1.4 above (pp. 284–285).
198 See Section 4.3.1 above (pp. 291–293).
199 Guido Tabellini and Charles Wyplosz, 'Supply-side Policy Coordination in the European Union' (2006) 13 *Swedish Economic Policy Review* 101, at 108–109.

as, consumer protection and environmental protection, where foreign and domestic sellers would have the same interests to lobby the centralised government if these policies were decided at the EU level.[200] Due to the fact that investment conduct supervision has a similar protected target as consumer protection, domestic and foreign investment firms may have aligned interests to lobby. Therefore, the AC_2 and TC_2 lines would be more like the reality in this case of investment conduct supervision, which means the higher level of Europeanisation would not be a better alternative in the EU for reducing the costs caused by opportunism.

4.4. Comparison of Costs Incurred by Bounded Rationality

In practice, aligning and channelling self-interested governments towards pursuing the public interest could not guarantee good policy outcomes, because the governmental failures may often be 'the result of fallibility rather than culpability'.[201] The public choice theory is incomplete to the story: the 'omniscience' assumption of regulators shall also be removed by the cognitive model.[202] Supervisors are boundedly rational too.[203] Process-based judicial review of agency decisions might play an important role in de-biasing,[204] but judicial review would never prevent all biased decisions making by public agencies since judges also have their own cognitive biases.[205] Given the bounded

200 Massimo Bordignon, Luca Colombo and Umberto Galmarini, 'Fiscal Federalism and Lobbying' (2008) 92 *Journal of Public Economics* 2288, at 2288–2297.
201 Jeffrey J. Rachlinski and Cynthia R. Farina, 'Cognitive Psychology and Optimal Government Design' (2002) 87 *Cornell Law Review* 549, at 554.
202 Ibid, at 607–615.
203 See further in Section 3.2.3 of CHAPTER IV (pp. 157–159).
204 Mark Seidenfeld, 'Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking' (2002) 87 *Cornell Law Review* 486, at 522–525, 543–547; Stephen J. Choi and A. C. Pritchard, 'Behavioral Economics and the SEC' (2003) 56 *Stanford Law Review* 1, at 37–38.
205 See, e.g., Jeffrey J. Rachlinski, 'A Positive Psychological Theory of Judging in Hindsight' (1998) 65 *The University of Chicago Law Review* 571, at 571–625; Donald C. Langevoort, 'Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review' (1998) 51 *Vanderbilt Law Review* 1499, at 1506–1519.

rationality of supervisors is difficult to be overcome, it might be better to have different supervisory systems that would reduce the harmful effect of behavioural biases among supervisors by positive learning effects.[206]

4.4.1. Decentralisation: Laboratory Federalism

Based on the standard approach of the federalism theory, it is argued that '[e]ach city or town is a laboratory where experiments are tried. If successful, the experiment is copied by other town governments. If it fails, the experiment is soon abandoned.'[207] The concept of 'laboratory federalism' was coined by Professor Oates in 1999,[208] with some followers[209] claiming that decentralisation can lead to a process of experimentation for policy innovation and learning. Although these positive benefits of decentralisation (such as, mistake-ridden learning, flexibility and option discovery) are normally neglected,[210] the findings of behavioural economics attract some new attention on this: decentralisation could be a mechanism to reduce cognitive errors.[211]

The benefits of this 'laboratory' are supported strongly by the evolutionary economics of private enterprises,[212] and provides a theoretical background for the

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206 Oskari Juurikkala, 'Behavioral Paradox: Why Investor Irrationality Calls for Lighter and Simpler Financial Regulation' (2012) 18 *Fordham Journal of Corporate & Financial Law* 33, at 91.

207 Paul E. Peterson, *The Price of Federalism* (Brookings Institution, 1995), at 19.

208 W. E. Oates, 'An Easy on Fiscal Federalism', above note 45, at 1131–1134.

209 See, e.g., K Kollman, JH Miller and SE Page, 'Decentralization and the Search for Policy Solutions' (2000) 16 *Journal of Law, Economics, and Organization* 102, at 102–128; Wolfgang Kerber, 'Applying Evolutionary Economics to Public Policy – The Example of Competitive Federalism in the EU' in Kurt Dopfer (ed), *Economics, Evolution and the State: The Governance of Complexity* (Edward Elgar, 2005), at 296–324; Nicole J. Saam and Wolfgang Kerber, 'Policy Innovation, Decentralised Experimentation, and Laboratory Federalism' 16 *Journal of Artificial Societies and Social Simulation* 7, available at: <http://jasss.soc.surrey.ac.uk/16/1/7.html> (accessed June, 2017)

210 Giampaolo Garzarelli, 'Cognition, Incentives, and Public Governance: Laboratory Federalism from the Organizational Viewpoint' (2006) 34 *Public Finance Review* 235, at 237–240.

211 William N. Eskridge Jr. and John Ferejohn, 'Structuring Lawmaking to Reduce Cognitive Bias: A Critical View' (2002) 87 *Cornell Law Review* 616, at 641–642.

212 For a comprehensive work of this: see Bart Nooteboom, *Learning and Innovation in Organizations and Economies* (Oxford University Press, 2001), Chs. 12 and 13.

application of 'Open Method of Co-ordination' ('OMC') in the EU.[213] This is a new mode of EU governance instruments towards a paradigm of collective learning.[214] The OMC, although it is applied in social policies mainly, is an explicit case of promoting policy learning between Member States by a soft approach of benchmarking (namely, best practices).[215] To some extent, the OMC may also link to the yardstick competition argument mentioned above,[216] but, here, the OMC is viewed as an effort to solve a different problem—that is, supervisors are boundedly rational.

4.4.2. Increased Costs after Centralised Investment Conduct Supervision

If supervisors would never know where is the optimum point of the Europeanisation's level, the theory of supervisory competition could be understood from another perspective. As shown by Figure VI-4 below, competition between Member States A and B has to be examined as the composition of many-times interaction over time.[217] Initially, at point L_i, Member States A and B have their own costs, and they then try to enhance the level of Europeanisation to point L_{ii}. After

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213 Wolfgang Kerber and Martina Eckardt, 'Policy Learning in Europe: the Open Method of Co-ordination and Laboratory Federalism' (2007) 14 *Journal of European Public Policy* 227, at 227–247.

214 Notis Lebessis and John Paterson, 'Developing New Modes of Governance' in Olivier De Schutter, Notis Lebessis and John Paterson (eds), *Governance in the European Union* (OOPEC, 2001), at 288–292; Dermot Hodson and Imelda Maher, 'The Open Method as a New Mode of Governance: The Case of Soft Economic Policy Co-ordination' (2001) 39 *Journal of Common Market Studies* 719, at 728.

215 For deeper discussion about the OMC: See, e.g., Caroline de la Porte, Philippe Pochet and Belgium Graham Room, 'Social Benchmarking, Policy Making and New Governance in the EU' (2001) 11 *Journal of European Social Policy* 291, at 291–307; Susana Borrás and Kerstin Jacobsson, 'The Open Method of Co-ordination and New Governance Patterns in the EU' (2004) 11 *Journal of European Public Policy* 185, at 185–208; Mary Daly, 'Whither EU Social Policy? An Account and Assessment of Developments in the Lisbon Social Inclusion Process' (2008) 37 *Journal of Social Policy* 1, at 1–19.

216 See, e.g., Pierre Pestieau, *The Welfare State in the European Union: Economic and Social Perspectives* (Oxford University Press, 2006), at 61; Arthur Benz, 'Multilevel Governance in the European Union: Loosely-Coupled Arenas of Representation, Participation and Accountability' in Simona Piattoni (ed), *The European Union: Democratic Principles and Institutional Architectures in Times of Crisis* (Oxford University Press, 2015), at 208. See further in Section 4.2.1 above (pp. 287–288).

217 For a formal model of this: see Ana B. Ania and Andreas Wagener, 'Laboratory Federalism: The Open Method of Coordination (OMC) as an Evolutionary Learning Process' (2014) 16 *Journal of Public Economic Theory* 767, at 771–782.

Member States A and B realised that a higher level of Europeanisation may reduce their costs, they keep doing this as an on-going experiment. This experiment then would continue until point L_{iv}, because, once over point L_{iii}, Member State A would learn that any further Europeanisation is without benefit. In contrast, Member State B would insist further Europeanisation for saving more costs. In this sense, the supervisory competition turns to be a 'laboratory' for each Member State: they learn, innovate and evolve by the mechanism of decentralisation. The TC lines, namely TC_A and TC_B, are not clear in the mind of Member States A and B, but are draw later after many tries.

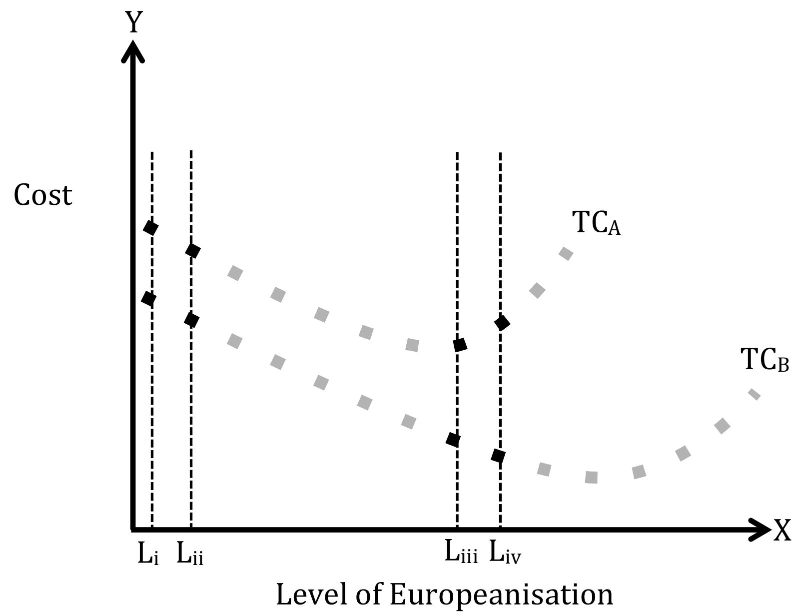

Figure VI-4: Comparison of Costs Incurred by Bounded Rationality between Centralisation and Decentralisation in the EU

By admitting the unreality of the omniscience assumption of supervisors, centralised supervision in a blind way will result in the risk of losing diversity,[218] followed by a reduction of the abilities to innovate and learn. 'By opening up the space

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[218] Eilis Ferran, 'Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model Symposium: Do Financial Supermarkets Need Super Regulators' (2002) 28 *Brooklyn Journal of International Law* 257, at 277.

for some institutional experimentation, a different opportunity structure is, perhaps, offered to the participants to exploit.'[219] In an even worse case, once financial institutions and supervisors all adopt similar business strategies, an error can result in heightened systemic risks.[220] Supervisory diversity provides a valuable, and little appreciated, hedge against systemic failures as a risk-sharing method.[221] This benefit of risk diversification generated by decentralisation is also supported by some empirical evidence.[222] Therefore, compared to the single supervisor, the network-based structure of ESMA, which essentially follows an OMC approach in the field of investment conduct supervision,[223] may provide a better system in reducing the costs caused by bounded rationality. This directly deliberative poly-archy ('DDP') of Member States provides a machine for learning from diversity.[224] As the official motto of the EU indicates, 'United in diversity'.[225]

5. Concluding Remarks

In this chapter, the current network-based system and the centralised supervision of investment conduct have been compared in detail from the perspective of

[219] Helen Wallace, 'Flexibility: A Tool of Integration or a Restraint on Disintegration?' in Karlheinz Neunreither and Antje Wiener (eds), *European Integration After Amsterdam: Institutional Dynamics and Prospects for Democracy* (Oxford University Press, 2000), at 190.
[220] R. Herring and R.E. Litan, *Financial Regulation in the Global Economy* (Brookings Institution, 1995), at 8.
[221] Roberta Romano, *Against Financial Regulation Harmonization: A Comment* (Yale Law & Economics Research Paper No 414, 2010), at 18–21.
[222] Alessandra Arcuri and Giuseppe Dari-Mattiacci, 'Centralization versus Decentralization as a Risk-Return Trade-Off' (2010) 53 *Journal of Law and Economics* 359, at 359–378.
[223] Elliot Posner, 'The Lamfalussy Process: Polyarchic Origins of Networked Financial Rule-Making in the EU' in Charles F Sabel and Jonathan Zeitlin (eds), *Experimentalist Governance in the European Union: Towards A New Architecture* (Oxford University Press, 2010), at 54–57; Christian Schweiger, *The EU and the Global Financial Crisis: New Varieties of Capitalism* (Edward Elgar, 2014), at 50.
[224] Charles F. Sabel and Jonathan Zeitlin, 'Learning from Difference: The New Architecture of Experimentalist Governance in the EU' (2008) 14 *European Law Journal* 271, at 276.
[225] Article I-8 of Treaty establishing a Constitution for Europe, 2004 OJ C310/01.

administrative regulation. Thanks to the principles of subsidiarity and proportionality, the EU Treaties guarantee a comprehensive institutional comparison to prevent any undue movement of Europeanisation. First of all, it was questioned whether the co-operation between Member States 'cannot be sufficiently achieved' in the current network-based supervision along with ESMA's intervention, in particular the principle of sincere co-operation as set out in the TFEU. Furthermore, based on the transaction cost approach, the total transaction costs would not be reduced, but even increased, after the introduction of centralised supervision of investment conduct. Specifically, the transaction cost comparison between the current supervisory system and the centralised supervision of investment conduct could be summarised as at Table VI-1 below. Given the increased transaction costs after centralisation, it is highly doubtful that the proposed establishment of a single supervisor in charge of investment conduct supervision in the CMU could pass the 'cannot be sufficiently achieved' test and/or the 'better achieved' and 'necessary to achieve' tests within the principles of subsidiarity and proportionality.

Table VI-1: Transaction Cost Comparison between Current Supervisory System and Centralisation of Investment Conduct Supervision

Organisational Failures Framework		**Costs After Centralisation?**
Environmental Factors	Uncertainty/Complexity	Increase
	Small Numbers	Increase
Human Factors	Opportunism	Increase
	Bounded Rationality	Increase
	Total Transaction Costs	**Increase**

Therefore, as the negative answer from the perspective of private law governance, the argument in favour of the establishment of a single supervisor in charge of investment conduct supervision for reducing transaction costs in the European capital markets cannot be made from the perspective of administrative governance either. In fact, other than establishing a centralised supervisor in the CMU, we may have to pay more attention to ensuring ESMA plays its role in effectively coordinating and supporting NCAs' investment conduct supervision,[226] in particular, implementation and convergence of supervisory practices will be the focus of ESMA over the next few years.[227]

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[226] Professor Moloney holds a similar expectation regarding governance issues of CMU. However, unlike this study focusing on whether the investment conduct supervision should be supervised centralisedly in the EU, she analyses a question regarding whether the capital market will be supervised centralisedly in the EU. See Niamh Moloney, 'Institutional Governance and Capital Markets Union: Incrementalism or A 'Big Bang'?' (2016) 13 *European Company and Financial Law Review* 376 at 333–336; see also N. Moloney, 'Capital Markets Union: "Ever Closer Union" for the EU Financial System?', above note 147, at 412–420.

[227] ESMA, ESMA Strategic Orientation 2016-2020, ESMA/2015/935, June, 2015, at 12–14, available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-935_esma_strategic_orientation_2016-2020.pdf> (accessed June, 2017).
See also ESMA, 2017 Work Programme, ESMA/2016/1419, September, 2016, at 4, 8–15, available at: <https://www.esma.europa.eu/sites/default/files/library/esma-2016-1419_-_esma_2017_work_programme.pdf> (accessed June, 2017).

CHAPTER VII

CONCLUSION

'Governance is an organizing concept for many fields in all social sciences; it is not a field per se, and certainly not a field within economics. Case studies in law, political science, sociology, and anthropology, and game-theoretic modeling in economics, have all contributed to the advancement of our knowledge concerning governance institutions. This offers a unique opportunity for the social sciences to have a meeting point, if not for reunification, after their separation over a century ago.'[1]

Since the financial markets in the EU were 'shocked' by the financial crisis of 2007–09, policymakers has been initiating many reforms in the European internal market. The establishment of the EBU for supervision and resolution of the Eurozone's major banks is a core reform to stabilise and strengthen the single currency.[2] The CMU is complementary to the EBU in improving risk diversification and resilience to banking shocks.[3] Notwithstanding having a similar name as to the term 'Union', the CMU is directed at achieving integration of markets across all Member States by removing barriers to capital flows and stimulating the development of European capital markets.[4]

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1 Avinash Dixit, 'Governance Institutions and Economic Activity' (2009) 99 *American Economic Review* 5, at 6.

2 For more information about the EBU, available at: <http://ec.europa.eu/finance/general-policy/banking-union/index_en.htm> (accessed June, 2017).

3 European Commission, Green Paper: Building a Capital Markets Union, COM(2015) 63 final, February, 2015, at 4, available at: <http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf> (accessed June, 2017).

4 European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Action Plan on Building a Capital Markets Union, COM(2015) 468 final, September, 2015, at 4, available at:

Also, it is distinct from other unions in the EU, since the legislative framework to support cross-border investment conduct is already in place broadly (such as, MiFID II/MiFIR and ESMA).[5] This legislative framework is formed by the fundamental freedoms of the Treaty of Rome initially, along with over fifty-year on-going reforms.[6] However, these efforts might not be enough to tackle the remaining obstacles in the CMU. This thesis is an attempt to analyse these obstacles, and whether these obstacles could be resolved by further centralisation of supervision at the EU level. It has attempted to explore the institutional governance of investment conduct in the EU and sought to address one primary research question: namely, 'whether investment conduct should be supervised centralisedly at the EU level in the CMU (or not)'?

Indeed, the current regulatory system of investment conduct faces many challenges,[7] but this does not necessarily lead to a positive answer of having a single European supervisor.[8] Based on the transaction cost approach,[9] this thesis holds a negative answer instead. This is supported by the result of a two-fold institutional comparison. First, by taking into account the regulatory role and the Treaty limitations of European private law, private law governance of investment conduct is still decentralised and very divergent in Member States.[10] Given the UK's experience, this

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<http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf> (accessed June, 2017).

5 See further in Section 3.3 of CHAPTER II (pp. 32–60) and Section 3 of CHAPTER III (pp. 84–103).

6 See further in Sections 2, 3.1 and 3.2 of CHAPTER II (pp. 17–32) and Section 2 of CHAPTER III (pp. 73–83).

7 See further in Section 4 of CHAPTER II (pp. 61–71) and Sections 4.1–4.3 of CHAPTER III (pp. 105–128).

8 See further in Section 4.4 of CHAPTER III (pp. 128–130).

9 See further in CHAPTER IV (pp. 133–192).

10 See further in Sections 2 and 3 of CHAPTER V (pp. 195–212).

may cause many complexities and problems in the European capital markets.[11] However, the establishment of a single supervisor in charge of investment conduct provides very little help in resolving these.[12] In contrast, an optional pan-EU ADR for capital market disputes, next to the national judicial systems, might be a better initiative in the CMU to reduce transaction costs.[13] Second, even if focusing on administrative governance merely, transaction costs in the CMU may not decrease, but even increase, after the establishment of a single supervisor in charge of investment conduct supervision.[14] Therefore, the establishment of a single supervisor in charge of investment conduct supervision is hard to pass the principles of subsidiarity and proportionality.[15] In fact, within the current network-based supervisory system, NCAs have an obligation to co-operate,[16] and ESMA has enough powers for tackling relevant issues in cross-border transactions already.[17] We have to pay more attention on ensuring ESMA plays its role effectively in the CMU.

In other words, through the lens of the transaction cost approach, the relationship between the current system, the proposed single supervisor and the optimum governance of investment conduct could be explained as following Figure VII-1.[18]

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[11] See further in Section 4 of CHAPTER V (pp. 212–250).
[12] See further in Section 5.1 of CHAPTER V (pp. 250–252).
[13] See further in Section 5.2 of CHAPTER V (pp. 252–255).
[14] See further in Section 4 of CHAPTER VI (pp. 275–300).
[15] See further in Section 2 of CHAPTER VI (pp. 262–271).
[16] See further in Section 3 of CHAPTER VI (pp. 271–274).
[17] ESMA now has not only many soft and hard powers to NCAs, but also some direct supervisory powers to financial institutions. See further in Sections 3.2 and 3.3 of CHAPTER III (pp. 88–105).
[18] This line is the same as the line L3.3 in CHAPTER IV (p. 189).

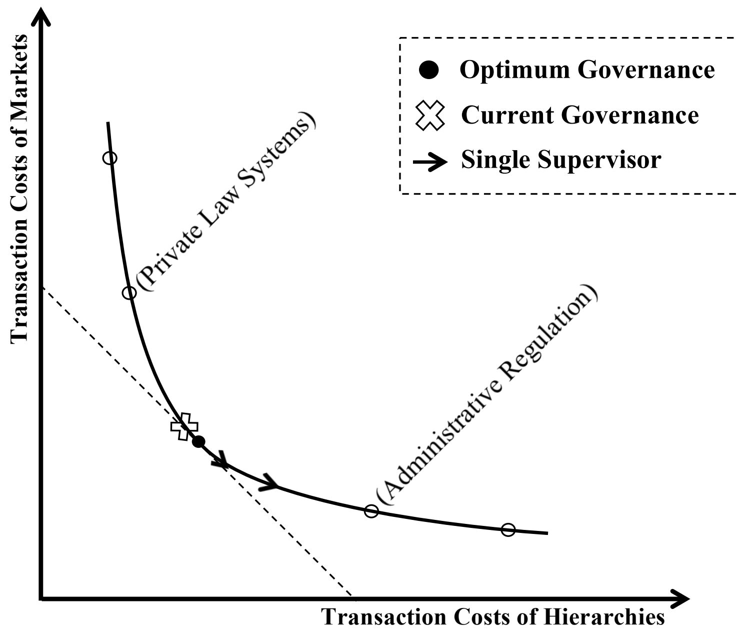

Figure VII-1: Relationship between Current Status, Single Supervisor and Optimum Governance of Investment Conduct in the EU

The current system (✧), as examined by this thesis, is not the perfect one, so it is not on the optimum point (●) of governance. Furthermore, given that, either from the perspective of private law systems or administrative regulation, the establishment of a single supervisor will not lower (but even increase) the total transaction costs of the CMU, the proposed single supervisor (⟶) represents a 'too much' move towards administrative regulation. The CMU merely needs 'a little' move to reduce its transaction costs, so a pan-EU ADR might be a better option. In the light of this, it not only indicates that the capacity of private law for governing investment conduct is normally ignored by policymakers in the EU, but also highlights the importance of hybrid investment conduct governance between private law systems and administrative regulation. The EU should have a more comprehensive viewpoint of European capital markets law in relation to the trend of 'Europeanisation', in order to establish the optimum governance of investment conduct in the CMU.

Doubtless, the present study will not put an end to the lively debate about the necessity of a single supervisor of investment conduct supervision in the CMU. Nonetheless, it is hoped that this thesis could shed new light on this sensitive and pressing issue. Since the UK triggered the Brexit process on 29th March, 2017,[19] the UK, (a home country of many investment firms which uses a different currency and unjoins the plan of SSM) will not be able to participate the policymaking of CMU anymore. Will this make the UK turn to be a competitor of the CMU, leading to a single supervisor in charge of investment conduct supervision in the CMU?[20] This question calls for follow-up research on the forthcoming changes in the CMU in the context of Eurozone, SSM and the competitive pressure from the UK's capital market.

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[19] A letter from the British Prime Minister, Theresa May, notifying the United Kingdom's intention to leave the European Union (29th of March, 2017), available at: <http://www.consilium.europa.eu/en/press/press-releases/2017/03/pdf/070329_UK_letter_Tusk_Art50_pdf/> (accessed June, 2017).

[20] The EU also noticed this issue recently: see European Commission, Public Consultation on the Operations of the European Supervisory Authorities, March, 2017, at 4, 16 and 22, available at: <https://ec.europa.eu/info/sites/info/files/2017-esas-operations-consultation-document_en.pdf> (accessed June, 2017).

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