"MUTUAL RECOGNITION" AND CROSS-BORDER FINANCIAL SERVICES IN THE EUROPEAN COMMUNITY

E. WAIDE WARNER*

I
INTRODUCTION

One of the pillars of the European Commission's ("Commission") single market program is the removal of Member State[1] barriers to the provision of financial services throughout the European Community ("Community").[2] The Commission's goal is to make a broad spectrum of banking, securities, and insurance services available Community-wide. The integration of the Community's financial services markets, particularly when coupled with the removal of restrictions on the flow of capital within the Community,[3] can be expected to spur competition among financial intermediaries, increase efficiency in the financial services industry, provide bank and insurance customers and securities investors with greater choice, and reduce the cost of capital for borrowers and issuers.[4] The development of Community-scale capital markets may also provide a catalyst for change in the climate for European Community takeover bids, particularly in countries where underdeveloped equity markets have impeded the growth of takeover activity.[5] The Commission does not intend, however, for the achievement of a

* Partner, Davis Polk & Wardwell, New York, New York.

I am grateful for the comments and suggestions of Marc Dassesse, Senior Lecturer on Tax Law at the University of Brussels and the Institute of European Studies, Brussels.

I am also grateful to several associates and summer associates of Davis Polk & Wardwell who provided valuable research assistance, particularly Joseph Hadley, John Connolly, Ada Clapp and Show-Mao Chen. Randal Quarles, now Deputy Assistant Secretary for Financial Institutions Policy, Department of the Treasury, provided the inspiration.

1. The 12 member states in the European Community are Belgium, Denmark, Germany, Greece, France, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, and The United Kingdom. In addition, Austria, Cyprus, Finland, Malta, Sweden, Switzerland, and Turkey have applied for European Community membership.

2. See *Completing the Internal Market*: White Paper from the Commission to the European Council, COM(85)310 final (June 14, 1985) ("The White Paper").

3. See John A. Usher, *1992 and the Implications for Banking and Finance: An Overview*, in Ross Cranston, ed, *The Single Market and the Law of Banking* 11-14 (Lloyds' of London Press, 1991) ("*Single Market*").

4. See Directorate-General for Economic and Financial Affairs, Commission of the European Communities, *The Economics of 1992: An Assessment of the Potential Economic Effects of Completing the Internal Market of the European Community, No 35*, 86-94 (March 1988).

5. See generally Study by Coopers & Lybrand, *Barriers to Takeovers in the European Community* (Her Maj Stationery Office, 1989).

single market for Community financial services to result in a lowering of necessary prudential standards or supervisory oversight.[6]

In general, the Commission has pursued its goals in the financial services sector by means of "mutual recognition" regimes for the authorization and supervision of financial services providers. This approach is premised on a harmonization of basic standards and operates mainly on the principle of "home country control."[7] Thus, in general, a financial institution from one Member State of the Community would be permitted to provide services or establish branches in any other Member State of the Community, subject to primary prudential regulation by its "home" Member State. A limited degree of ancillary regulation would be provided by the "host" Member States, in which the institution offers its services.[8]

The adoption of a mutual recognition approach represented a significant change in the Commission's methodology for regulatory convergence in the Community. In 1985, the Commission published a seminal White Paper[9] that rejected the strict harmonization method previously employed in the effort to build the common market called for by the Treaty of Rome.[10] Under that method, the Commission had sought to achieve Member State agreement on comprehensive and detailed Community-wide standards. That effort proved too difficult and time-consuming given the many disparate traditions and interests of the various Member States and the unanimity required by Article 100 of the Treaty of Rome.[11] Under the mutual recognition approach embraced by the White Paper, however, only essential standards would be harmonized.[12] As a result, Member States with overly restrictive regulation

---

6. See generally George S. Zavvos, *The Integration of Banking Markets in the EEC—The Second Banking Coordination Directive*, 2 J Intl Banking L 53 (1988).

7. See The White Paper at 28 ¶ 103 (cited in note 2).

8. Id.

9. Id.

10. The Treaty Establishing the European Economic Community, [1958] 298 UNTS 11 ("Treaty of Rome").

11. Article 100 of the Treaty of Rome empowers the Council of the European Communities, "acting unanimously on a proposal from the Commission, [to] issue directives for the approximation of such provisions laid down by law, regulation or administrative action in Member States as directly affect the establishment or functioning of the common market." Obtaining unanimous approval of detailed and technical regulations (as opposed to basic standards) affecting areas where national concerns differ (such as consumer protection or the health, safety, and welfare of citizens) greatly delayed the decisionmaking process. See The White Paper at 19-20 (cited in note 2).

The unanimity requirement was later modified by the Single European Act, OJ(L#L 169,) which authorizes the Council, after consulting with the Economic and Social Committee of the European Community, to act by a qualified majority (utilizing weighted voting) on proposals from the Commission, except with respect to proposals relating to fiscal (largely tax) matters, the free movement of persons, or the rights and interests of labor. See Treaty of Rome at art 100a.

12. The White Paper at 19-20, 22-23 (cited in note 2). The Commission's promulgation of the mutual recognition approach was facilitated by prior rulings of the European Court of Justice striking down Member State restrictions on the importation of goods lawfully produced in another Member State. See, for example, Case 120/78 *Rewe-Zentral AG v Bundesmonopolverwaltung fur Branntwein*, [1979] 3 CMLR 494, 663 (1979) ("There is . . . no valid reason why, provided that they have been lawfully produced and marketed in one of the Member States, [goods] should not be introduced into any other Member State" except where restrictions and regulations "serve a purpose which is in the general interest and such as to take precedence over the requirements of the free movement of goods, which constitutes one of the fundamental rules of the Community.").

would be pressured to deregulate—but not below the essential standards—in order not to disadvantage their domestic institutions, which would be faced with less-regulated competitors from other Member States. Thus, the mutual recognition approach encourages convergence of standards through competition among diverse systems of regulation.[13]

This article discusses the application of the mutual recognition approach to the provision of cross-border banking and investment services in the European Community.[14] It begins with a brief discussion of the basis in the Treaty of Rome for the Commission's single market program for financial services. The article then addresses the regulation of financial intermediaries under the mutual recognition regimes of the Second Banking Directive,[15] the proposed Investment Services Directive,[16] the UCITS Directive,[17] the Listing Particulars Directive,[18] and the Prospectus Directive.[19] The article concludes with a discussion of several outstanding issues with respect to the Community's system of financial services regulation.[20]

---

13. See Joseph A. Grundfest, *Internationalization of the World's Securities Markets: Economic Causes and Regulatory Consequences*, 4 J Fin Serv Res 349, 371-73 (1990).

14. A discussion of the Community's progress toward a mutual recognition regime in the various areas of insurance regulation is beyond the scope of this article.

15. Council Directive 89/646, 1989 OJ (L 386) (amending Directive 77/780) ("Second Banking Directive").

16. Amended Proposal for a Council Directive, 90/C 42/06, 1990 OJ (C 42) ("Investment Services Directive").

17. Council Directive 85/611, 1985 OJ (L 375/3) (on Undertakings for Collective Investment in Transferable Securities) ("UCITS Directive"), as amended by Council Directive 88/220, 1988 OJ (L 100/31) ("March 22 Directive").

18. Council Directive 80/390, 1980 OJ (L 100/1) ("Listing Particulars Directive") as amended by Council Directive 87/345, 1987 OJ (L 185/81) ("June 22 Directive"), Council Directive 90/211, 1990 OJ (L 112/24) ("April 23 Directive"), and Council Directive 82/148, 1982 OJ (L 62/22).

19. Council Directive 89/298, 1989 OJ (L 124/8) ("Prospectus Directive").

20. Major recent developments would both broaden and deepen the Community and would change the context in which the mutual recognition approach operates. The Treaty on European Union, or the "Maastricht Treaty," was entered into by the heads of the Community's Member States on February 7, 1992. Treaty on European Union, 31 Intl Legal Mat 247 (1992). The Maastricht Treaty proposes a number of amendments to the three founding treaties of the Community with the purpose of fostering a closer political, economic, and monetary union.

While the Maastricht Treaty does not address directly the specific subject matter of the directives discussed in this article, it re-affirms the Member States' commitment to the "free movement of goods, persons, services and capital" within the Community, as it was first set out in the Treaty of Rome. Id art G(3) at 257.

In addition, in order to address concerns about Member State sovereignty, which often are reflected in resistance to the mutual recognition approach in areas in which fiscal and monetary policy could be affected, Article B of the Maastricht Treaty provides that "[t]he objectives of the Union shall be achieved . . . while respecting the principle of subsidiarity." Id at 255. Article G(5) amends the Treaty of Rome to define subsidiarity thus:

> In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.

Id at 258.

So far, the Maastricht Treaty has been ratified by national referenda in Ireland and France, and by parliamentary vote in Greece and Luxembourg, but failed to win approval in the Danish referendum.

II

TREATY PROVISIONS RELATING TO FINANCIAL SERVICES

The mutual recognition/home country control approach to financial services in the Community is intended by the Commission to implement two of the basic freedoms guaranteed within the Community by the Treaty of Rome: the "freedom of establishment"[21] (as part of the "free movement of persons"[22]) and the "freedom to provide services."[23] These freedoms, together with the "free movement of goods,"[24] and the "free movement of capital,"[25] are fundamental freedoms protected by the Treaty.

The freedom of establishment encompasses the right of a Member State national to set up a business in another Member State as though a national of that other Member State.[26] Article 52 of the Treaty of Rome states, in part:

> [R]estrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be abolished by progressive stages .... Such progressive abolition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Freedom of establishment, then, includes the right to set up and manage companies under the same conditions applicable to nationals of the Member State where the establishment is sought.

Controversy over the Maastricht Treaty and related turmoil in the Community currency markets have raised doubts regarding whether it will ultimately go into effect in its current form.

On May 6, 1992, the Community entered into an agreement with the European Free Trade Association ("EFTA") on the creation of the European Economic Area ("EEA"). The new agreement is expected to come into effect on January 1, 1993, after ratification by the European Parliament and the national legislatures of the Community and EFTA Member States, and by a national referendum in the case of Switzerland. The EEA is widely expected to be a transitional arrangement before the EFTA countries become full Member States of the Community. Of the seven EFTA countries, Austria, Sweden, Finland, and Switzerland have applied for membership in the Community; Norway, Iceland, and Liechtenstein have not.

The new agreement aims to "establish a dynamic and homogenous EEA, based on common rules and equal conditions of competition." See Opinion of the Court of Justice of the European Communities Regarding the Draft Agreement Between the European Community and the European Free Trade Association Relating to the Creation of the European Economic Area, Dec 14, 1991, 3 Intl Legal Mat 442, 445 (1992) (quoting the preamble to the draft EEA agreement). The body of common rules to be applied in the EEA will be "substantially identical to that which is in force within the EEC." Id at 451. Subject to certain exceptions and transitional provisions for the individual EFTA countries contained in Annex IX to the EEA agreement, the directives discussed in this article will apply to the EFTA countries after the EEA comes into effect. It should be noted, however, the directives not yet adopted by the Community, such as the proposed Investment Services and Capital Adequacy Directives, will not automatically become part of EEA law. They are expected, however, to be adopted by the EFTA countries.

21. Treaty of Rome at arts 52-58 (cited in note 10).

22. Id at arts 48-58.

23. Id at arts 59-66. The Community's goal is "the creation of a unified banking market based on mutual recognition of financial standards and a single banking licence valid throughout the EC." George S. Zavvos, *1992: One Market*, Intl Fin L Rev 7 (March 1988). Under this unified banking market, a Community bank would be permitted to establish branches and to provide financial services throughout the Community without establishment outside its home Member State. Id.

24. Treaty of Rome at arts 9-37 (cited in note 10).

25. Id at arts 67-73.

26. Id at art 52.

The freedom to provide services is the right of a Community national (for example, a firm established in a Member State) to provide services across Member State boundaries without the need to establish outside the home Member State.[27] This right is addressed in article 59 of the Treaty of Rome:

> Restrictions on freedom to provide services within the Community shall be progressively abolished . . . in respect of nationals of Member States who are established in a state of the Community other than that of the person for whom the services are intended.

The freedom of establishment and the freedom to provide services are directly infringed by provisions of a Member State's law that discriminate against businesses from other Member States.[28] Even in the absence of discrimination, however, a Member State's nondiscriminatory standards can be costly and can duplicate or conflict with standards of other Member States, thereby indirectly favoring domestic businesses. Although both the freedom of establishment and the freedom to provide services are expressly protected by the Treaty of Rome, the practical implementation of these freedoms is generally best achieved through the process of Community legislation rather than through the arduous and uncertain process of case law development.[29] The Commission's approach to the realization of the freedom of establishment and the freedom to provide services in the financial services area has been primarily through Community financial services initiatives that provide a framework in which Community banks and securities firms may set up branches or subsidiaries and transact their business in any Member State.[30]

A. The Second Banking Directive

The general rule of the Second Banking Directive is that each Member State must recognize the license granted to a Community credit institution by any other Member State, and that all core activities[31] engaged in by a credit

---

27. For an excellent discussion of the right of establishment and the freedom to provide services, see Derrick Wyatt & Alan Dashwood, *The Substantive Law of the EEC* 198-223 (Sweet & Maxwell, 2d ed 1987).

28. See Case C-175/88 *Biehl v Administration des Contributions du Grand-Duche de Luxembourg*, [1990] 3 CMLR 143 (Member State income tax provisions that directly or indirectly discriminate against workers from other Member States based on nationality violate article 48(2) of the Treaty of Rome guaranteeing freedom of movement for workers).

29. A legislative approach to fulfilling the freedom of establishment and the freedom to provide services is preferable to reliance upon case law development for several reasons. First, because directives are reviewed by three political bodies (drafted by the Commission, considered by the European Parliament, and adopted by the Council of Ministers), they are subject to a broader range of social, economic, and political considerations than are generally considered in case-specific decisionmaking. Second, because the outcome of litigation is, to a great extent, dependent upon a litigant's ability as an advocate and because such decisions are binding only upon those to whom they are addressed, a legislative approach is a more reliable means of both realizing the freedoms guaranteed by the Treaty of Rome and ensuring some uniformity among the Member States in so doing. Litigation, however, has been an important factor in expanding the boundaries of legislation. See note 12.

30. See generally Zavvos, Intl Fin L Rev at 7 (cited in note 23).

31. Among these activities are deposit-taking and other forms of borrowing, consumer credit, mortgage lending, trade finance, securities underwriting, securities trading, and portfolio

institution[32] in the Community are to be regulated by its home Member State.[33] The result is a type of extraterritorial regulation by the home Member State, whose domestic regulation continues to govern the business activities of its domestic enterprises conducted in any other Member State.[34] For example, because the permitted banking activities include securities operations, a bank that is allowed to deal in securities in its home Member State would be allowed to deal in securities in any Member State, even if securities activities are prohibited for domestic credit institutions in the latter Member State. Similarly, an Italian branch of an English bank would be permitted to engage in mortgage lending in Italy, whether or not an Italian bank were permitted to do so, so long as banks in the United Kingdom were authorized to engage in mortgage lending.

The provisions of the Second Banking Directive establishing mutual recognition and home country control apply to the direct rendering of services across borders, as well as to services offered through a local branch of a credit institution established and regulated elsewhere in the Community. A subsidiary of a Community credit institution that is not itself a credit institution established in the Community would generally not be entitled to the benefits of the Directive.[35]

The Commission has established minimum harmonized supervisory standards for credit institutions in the Community through a number of legislative measures. The Second Banking Directive itself contains several such provisions: (1) a minimum capital ("own funds") level of five milllion European Currency Units ("ECU") (except for certain credit institutions with

management. The full set of activities subject to mutual recognition is listed in an annex to the Second Banking Directive. See appendix.

32. The term "credit institution" is defined by reference to Council Directive 77/780, 1977 OJ (L 322/30) (the "First Banking Directive"), which provides that a "credit institution" is any enterprise the business of which is to "receive deposits or other repayable funds from the public and to grant credits for its own account." The First Banking Directive exempts from its provisions a specific list of credit institutions, primarily those affected with a public interest or cooperative savings enterprises, and article 2(2) of the Second Banking Directive (cited in note 15) exempts the same institutions by reference to the list contained in the First Banking Directive. Among the exempted entities are central banks of Member States, post office giro institutions, credit unions and municipal banks. Importantly, branches of a non-Community credit institution are not generally treated as Community entities and thus may not benefit from the Second Banking Directive's liberalizations.

33. Under article 1(7) of the Second Banking Directive, the home Member State is the Member State in which a credit institution has its regulatory authorization. Second Banking Directive (cited in note 15).

34. As noted earlier, under this approach Member States with overly restrictive regulation put their domestic businesses at a distinct competitive disadvantage by subjecting them to more stringent requirements than those that apply to their counterparts established in host Member States in which the domestic businesses are operating. If the cost of regulation proves too high, domestic businesses of overregulated Member States may seek to re-establish themselves in less-regulated markets of other Member States. See Grundfest, 4 J Fin Serv Res at 372 (cited in note 13).

35. Article 18 of the Second Banking Directive provides, however, that a subsidiary of a credit institution that would fall outside the definition of "credit institution," for example, a securities subsidiary, may nonetheless be entitled to the benefits (or subject to the burdens) of home Member State supervision across Member State borders, provided that its activities are supervised on a consolidated basis with those of its parent credit institution, and that the parent credit institution holds 90% or more of the voting share capital of the subsidiary and guarantees the commitments entered into by the subsidiary. Second Banking Directive at art 18 (cited in note 15).

a restricted scope of business);[36] (2) a suitability requirement for directors, managers, and major shareholders of a credit institution;[37] (3) limits on the ability of a credit institution to hold shares in a nonfinancial institution;[38] and (4) a requirement that each Member State "ensure the existence within each credit institution of sound administrative and accounting procedures and adequate internal control mechanisms," although no particular procedures or controls are specified or required in the Directive.[39] In addition to the harmonization provisions contained within the Second Banking Directive itself, article 22 of the Directive provides for implementation concurrent with the Commission's directives on the measurement of credit institution capital and minimum solvency ratios.[40] Through these measures, the Commission has effected a standardization of Member State banking laws via the harmonization of minimum supervisory standards for Community credit institutions. This standardization provides the basic framework within which the mutual recognition regime can operate and prevents the possibility of a "race to the bottom" that could result from unrestricted regulatory competition.[41]

Pending further coordination of minimum standards within the Community, each host Member State shall retain (1) responsibility (in cooperation with the home Member State) for the supervision of the liquidity of credit institutions operating in the host Member State, as well as responsibility for implementation of host Member State monetary policy, in each case so long as the measures imposed do not embody discriminatory or restrictive treatment based on the location of the credit institution in another

---

36. Id at art 3.

37. Id at art 5.

38. The Second Banking Directive requires that any permitted non-banking activities of banks be supported ECU-for-ECU by capital. Subject to an increase in the amount of its own funds or other remedial measures, a credit institution may not maintain a "qualifying holding" in an amount greater than 15% of its own funds in any institution that is not (1) a credit institution, (2) a financial institution (defined as a company, other than a credit institution, which has as its principal activity any of the core activities permitted to a credit institution under the Directive except the taking of deposits and other repayable funds from the public), or (3) a company pursuing an activity that is a direct extension of banking or concerning services ancillary to banking, such as leasing, factoring, the management of unit trusts, data processing services, or any other similar activity. A "qualifying holding" is a direct or indirect holding that represents 10% or more of the capital or voting rights of a company, or that makes possible the exertion of a significant influence over management. The total of all qualifying holdings in non-financial institutions must not exceed 60% of a credit institution's own funds. Id at art 12.

These limits need not be observed if the amounts in excess of the limits are covered completely by the institution's own funds and those institution's own funds are not included in the calculation of the solvency ratio of the institution. Existing credit institutions with holdings exceeding the limits will be allowed a period of ten years to decrease those holdings or to cover those holdings by increasing their capital.

39. Second Banking Directive at 11 (cited in note 15).

40. See Council Directive 89/299, 1989 OJ (L 124/16) (as amended by Directive 92/16, 1992 OJ (L 75/48)) ("Own Funds Directive"), and Council Directive 89/647, 1989 OJ (L 386/14) ("Solvency Ratio Directive").

41. See Michael Gruson & Wolfgang Feuring, *A European Community Banking Law: The Second Banking and Related Directives*, in Cranston, *Single Market* at 28 (cited in note 3).

Member State,[42] and (2) the authority to take appropriate measures to prevent or punish irregularities committed by credit institutions operating within the host Member State's borders that violate rules adopted by the host Member State "in the interest of the general good."[43]

Additionally, article 14(3) of the Second Banking Directive requires home and host Member States' authorities to collaborate to ensure that credit institutions operating in the host Member State make sufficient provision against market risk with respect to operations in securities markets in the territory of the host Member State. This assurance is especially necessary because the Solvency Ratio Directive covers only credit risk—that is, risk attaching to the particular type of counterparty in a banking transaction—rather than the market or position risk involved in securities activities. However, the expected adoption of the Investment Services Directive and the Capital Adequacy Directive[44] should make collaborative efforts between individual home and host Member States to provide against position risk much less necessary.

B. Proposed Investment Services Directive

The proposed Investment Services Directive would provide for the prudential regulation of investment firms under a mutual recognition regime based on home country control and harmonized essential minimum prudential standards of behavior, similar to that established for credit institutions by the Second Banking Directive. The similarity of the two directives reflects the Commission's view that the Investment Services Directive and the Second Banking Directive should be closely interrelated in the interest of maintaining fair competition between banks and non-banks that provide investment services.[45] The Investment Services Directive also seeks to open up membership in Community securities exchanges, as well as in Community financial futures and options exchanges, to investment firms authorized to conduct these activities in their home Member State.[46]

The Investment Services Directive would apply to those in the business of providing investment services, which are defined by reference to the set of activities listed in an annex to the Directive.[47] In general, these activities would include the following: brokerage, dealing, market making, portfolio management, underwriting and distribution of securities, individual investment advice, and safekeeping and administration.

---

42. Second Banking Directive at art 14(2) (cited in note 15).

43. Id at art 21(5). For a more detailed discussion of the "general good" exception, see Part IIC.

44. See notes 16 and 51.

45. Investment Services Directive at 7 (cited in note 16). Many of the provisions in the Investment Services Directive are similar or identical to correlative provisions in the Second Banking Directive.

46. Id.

47. Id at annex.

The Directive would expressly permit these services with respect to some or all of the following instruments: transferable securities, money market investments, financial futures and options, and exchange rate and interest rate instruments.[48] The Directive would also permit ancillary services.[49]

To the extent that an investment firm is authorized by its home Member State[50] to engage in the listed investment services, it would be able to perform those services in other Member States as well, either across Member State borders or through the establishment of one or more branches within the boundaries of other Member States. Prudential supervision of the investment firm would be the responsibility of its home Member State and would cover such matters as the suitability of major shareholders and those who direct the business of the investment firm,[51] monitoring capital requirements,[52] and the

---

48. The scope of activities and instruments covered by the Investment Services Directive was the subject of much substantive negotiation and detailed drafting. For example, some commentators expressed concern that authorization for "underwriting" may not include authorization for the lead management of a syndicate of underwriters, which is a distinction drawn in Germany (ostensibly for monetary control reasons). See Tony Shea, *The Proposed Investment Services Directive*, in Cranston, *Single Market* at 130 n59 (cited in note 3). Similarly, the British Department of Trade and Industry (the "DTI") took the view that sub-underwriting should not be included as a permissible investment firm activity and that the term "distribution" is unclear. The DTI suggested that the term "placing" would be preferable. See British Department of Trade and Industry, *EC Investment Services Directive: A Consultative Document* at 6 ¶ 26 (July 1990).

49. Investment Services Directive at art 3(1) (cited in note 16).

50. Under the Investment Services Directive, the home Member State of an investment firm is the Member State in which it has its registered office (or, if it has none, its head office). Id at art 1(4)(b).

51. Id at arts 3(2), 4.

52. See id at arts 3(2), 9. The proposed Capital Adequacy Directive would establish minimum capital requirements to cover risks associated with the "trading book" activities of investment firms and credit institutions. See Common Position Adopted by the Council on 27/07/92 with a View to Adopting a Directive on the Capital Adequacy of Investment Firms and Credit Institutions, Eur Parl Doc (SYN 257)(1992). Trading book activities include (1) proprietary holdings in marketable investment instruments such as transferable securities, units in collective investment funds, financial futures and options, and (2) transactions such as repurchase agreements, securities borrowing, fees and commissions related to trading book activities. The risks associated with trading book activities for the purposes of the Capital Adequacy Directive include settlement risk, position risk, foreign exchange risk, and "other risks" related to fee-based work.

The proposed Capital Adequacy Directive would set initial minimum capital requirements for investment firms but not for firms which engage solely in the ancillary service of providing investment advice (which, conversely, would not have the benefit of a Community-wide authorization under the Investment Services Directive).

The form of capital which may be used to meet the proposed Capital Adequacy Directive requirements would include short-term subordinated debt, up to 250% of share capital and reserves as specified in article 2(1) of the Own Funds Directive (cited in note 40). This compares with (1) the minimum maturity of five years for qualifying subordinated debt and (2) the lower permitted maximum of 50% of core capital, which are requirements that the Own Funds Directive and the Solvency Ratio Directive (cited in note 40) would impose on the non-trading book exposures of both credit institutions and investment firms.

Under the proposed Capital Adequacy Directive, large exposures may exceed the general limit of 25% of capital for a period of 10 days, after which a sliding scale of additional capital requirements would apply, which become more onerous the longer the exposure remains on the trading book.

The proposed Capital Adequacy Directive would also provide for consolidated supervision of investment firms. However, unlike the Consolidated Supervision Directive (cited in note 118), which adequacy of accounting, record keeping, and internal control systems.[53] In addition, the home Member State would be responsible for requiring that investment firms have structural mechanisms in place to prevent conflicts of interest.[54] Finally, the home Member State would be responsible for two areas of investor protection: segregation of clients' funds and securities, and compensation arrangements with respect to investors' claims unpaid due to the default or bankruptcy of investment firms.[55]

The proposed Directive does not attempt to harmonize conduct of business or advertising rules. As a consequence, host Member States may regulate those areas "in the interest of the general good."[56]

In addition to ensuring that investment firms may pursue the activities covered by the Directive and any ancillary activities, host Member States must ensure that investment firms authorized to provide brokerage, dealing, or market-making services in their home Member States have access to membership in stock exchanges and organized securities markets of host Member States.[57] Host Member States must therefore ensure that investment firms from other Member States have the option to become members of national stock exchanges or organized securities markets either directly through branches, or indirectly through subsidiaries or by the acquisition of an existing member firm.[58]

A Community credit institution authorized by its banking license to engage in the securities business would not need a separate authorization under the proposed Investment Services Directive in order to provide investment banking services in other Member States.[59] As with investment firms, a credit institution's home Member State would have the responsibility for prudential regulation[60] and for requiring adequate provision against market risk.[61] In addition, each Member State would be obliged to ensure that credit institutions that are also engaged in investment banking have access to that Member State's stock exchanges.

---

regulates credit institutions, the proposed Capital Adequacy Directive would allow Member State authorities the discretion to exempt investment firms from consolidated supervision.

The proposed Capital Adequacy Directive may be further reviewed and modified upon recommendations submitted within three years after the Directive's effective date by a committee of representatives from the Member States.

53. Investment Services Directive at art 11(1) (cited in note 16).

54. Id.

55. Id.

56. Id at arts 16(5), (10). See discussion of the "general good" exception in Part IIC.

57. Investment Services Directive at art 13(1) (cited in note 16).

58. Id at art 13(2). Similarly, host Member States must ensure that investment firms authorized to deal in financial futures and options in their home Member State have access to financial futures and options exchanges in the host Member State. Id at art 13(4).

59. Id at art 2.

60. Id at art 11.

61. The provision of capital to guard against various market risks associated with the credit institution's "trading book" activities with respect to myriad marketable investment instruments is governed by the Capital Adequacy Directive (cited in note 52). These risks include position risk, settlement risk, and foreign exchange risk. As to the non-trading book activities of the credit institution, the applicable capital requirements are set out in the Solvency Ratio Directive (cited in note 40) and the Own Funds Directive (cited in note 40). See note 52.

Negotiations over the Directive reached an important breakthrough when the Council of Economics and Finance Ministers ("ECOFIN") of the Community agreed in principle on several major points in June of 1992.[62] Nevertheless, its simultaneous implementation with the Second Banking Directive is still doubtful. Securities firms are particularly concerned about these delays because of the competitive disadvantages they could suffer if the Investment Services Directive is not implemented simultaneously with the Second Banking Directive at the beginning of 1993. At that point, banks (either directly or through subsidiaries) will enjoy the freedom of a single market for securities activities in the Community, while securities firms that do not have the benefit of the Second Banking Directive would still be restricted by national regulation, with recourse only to the protections of the Treaty of Rome.[63]

C. Regulation on Grounds of "General Good"

The Second Banking Directive and Investment Services Directive each contain provisions allowing host Member States to impose rules justified by the "general good."[64] This exception gives Member States some latitude to continue to regulate banks and investment firms from other Member States that operate within their jurisdictions. The Directives do not define "general good," although any measures penalizing or restricting credit institutions or investment firms under this exception must be "properly justified and

62. See, for example, Henry Steuart, *ISD: In-Principle Agreement on Sticking Points*, Financial Regulation Report 6 (July 1992). Under the agreement reached by ECOFIN, regulated markets must publish at the beginning of each business day the average weighted price for each traded instrument, its highest and lowest prices, and the volume traded during the previous business day. In addition, each continuous trade-matching and automated quotation market must publish various price and trading volume information at hourly and shorter intervals. Member State authorities have the discretion to suspend these publication requirements in exceptional circumstances, such as where the trader's anonymity could be undermined by large transactions or transactions in illiquid markets. Authorized firms will be required to maintain records of trading activities and make them available to regulators no later than at the end of the following day.

Banks would be given direct access to national exchanges under the proposed Investment Services Directive, Amended Proposal for a Council Directive, 90/C 42/06, 1990 OJ (L42), although Member States which currently deny such access to banks may continue to do so through year-end 1996 (in the case of Belgium, France, and Italy) or year-end 1999 (in the case of Spain, Greece, and Portugal). The issue of direct bank access will be reviewed before these two dates.

Natural persons and partnerships may be authorized to do business under the proposed Investment Services Directive if they can give satisfactory assurances that they will be able to provide investors with protection comparable to that afforded by legal persons. Member States may also require that certain instruments be traded on regulated markets, unless the investor chooses otherwise.

63. See Simon London, *Fresh Try on Securities Directive*, Fin Times 27 (July 16, 1991); *ISE Chairman Blasts France Over ISD*, 2 Intl Sec Reg Rep (June 17, 1991); *SEAQ Seen As Starting Point*, id.

64. Second Banking Directive at art 21(5) (cited in note 15); Investment Services Directive at art 16(5), (10) (cited in note 16). Based on general principles of Community law, "to the extent that such principles may be extrapolated from the jurisprudence of the Court of Justice," commentators have argued that the term "general good" as used in these Directives refers to the general good of the Community as a whole, not the general good of the host Member State seeking to support its regulation on "general good" grounds. See, for example, Marc Dassesse, *Retail Banking Services in 1992*, in Cranston, *Single Market* at 66-67 (cited in note 3).

communicated."[65] The circumstances under which Member State regulation will be justified by the "general good" is thus left for resolution by the European Court of Justice.

Four related insurance cases decided by the European Court of Justice in 1986 provide some indication of the circumstances under which host country restrictions imposed on the ground of protecting the general good may be upheld.[66] France, Denmark, Germany, and Ireland had enacted laws requiring Member State insurers already established and authorized in their home state to apply for additional authorization in the Member State in which they sold insurance. In some cases the insurers were also required to maintain an establishment in the Member State in which they provided insurance services. The Commission considered these restrictions unjustified in light of the common authorization procedure established by article 6 of Council Directive 73/239,[67] which applies to all insurance undertakings in Member States. In the Commission's opinion, Member States were obliged to permit insurers authorized pursuant to this common procedure, though not physically established on their territory, to provide services within their territory.[68]

Member States attempted to defend these insurance regulations on "public interest" grounds, arguing that regulations in other Member States were inadequate, particularly with respect to the financial position and technical reserves of insurance companies as well as in the area of minimum standards of fairness in insurance contracts. The European Court of Justice found the restrictions to be impermissible infringements on the freedom to provide services in the case of co-insurance, due in large part to the sophisticated nature of the policyholders that customarily purchase such insurance.[69] In the case of general direct insurance, however, the Court held that host Member State authorization requirements, but not requirements of establishment, could be justified for three reasons: (1) an imperative public interest mandated that individual consumers be protected, both as policyholders and as insured persons, from the risk that an insurance company would either fail or impose oppressive contracts; (2) the public interest in question was not already protected by the rules of the Member

65. Second Banking Directive at art 21(6) (cited in note 15); Investment Services Directive at art 16(6) (cited in note 16).

66. Case 220/83 *Commission v France*, [1987] 2 CMLR 113 (1986); Case 252/83 *Commission v Denmark*, [1987] 2 CMLR 169 (1986); Case 205/84 *Commission v Germany*, [1987] 2 CMLR 69 (1986); Case 206/84 *Commission v Ireland*, [1987] 2 CMLR 150 (1986).

67. 1973 OJ (L #228) (regulations and administration of direct insurance other than life assurance).

68. *Commission v France*, [1987] 2 CMLR at 120-21; *Commission v Denmark*, [1987] 2 CMLR at 172; *Commission v Germany*, [1987] 2 CMLR at 82-83; *Commission v Ireland*, [1987] 2 CMLR at 154.

69. The Court rejected the argument that these restrictions were justified by the need for consumer protection, finding that co-insurance was likely to be taken out by large commercial, industrial, or governmental organizations, which have access to advice from either a legal expert or an independent, professional insurance broker and which are able to assess and negotiate insurance policies offered to them. *Commission v France*, [1987] 2 CMLR at 134; *Commission v Germany*, [1987] 2 CMLR at 110.

State of establishment;[70] and (3) the result achieved by authorization could not be obtained by less restrictive rules, although the requirement of a separate establishment was disproportionately restrictive and therefore impermissible.[71]

The particular facts that allowed the Court to find that host Member State regulation of general direct insurance services was "justified" appear less likely to exist with respect to the Second Banking Directive because the Second Banking Directive will not become effective until related directives on own funds and solvency ratios[72] (which set agreed-to minimum standards for the protection of customers and third parties against failures of credit institutions) have been implemented. Similarly, the Investment Services Directive will be implemented alongside the Capital Adequacy Directive, with its harmonized rules on capital requirements. If, however, the Court were to find host Member State regulation justified, it would most likely do so in the areas of retail rather than wholesale banking and investment services, as the Court has demonstrated its unwillingness to restrict the provision of services in order to protect presumably sophisticated institutional customers.

III

REGULATION OF FINANCIAL INTERMEDIARIES THROUGH OTHER MUTUAL RECOGNITION REGIMES

A. The UCITS Directive[73]

As with other financial intermediaries in the Community, the Commission has attempted to create a single market for open-end collective investment funds, known as "UCITS" in Community jargon, through a mutual recognition/home country control approach. Host Member State concerns regarding investor protection have been met primarily through the establishment of minimum standards of liquidity, diversification, disclosure, and asset management.

The UCITS Directive requires Member States to recognize any UCITS[74] authorized in another Member State, so long as it complies with certain notification and filing requirements. The primary responsibility for prudential regulation of a UCITS rests with its home Member State.[75] A

70. The Court found that existing Directives did not harmonize national rules regarding technical reserves (such as requiring that financial resources, other than the undertaking's own capital resources, be set aside to guarantee liabilities under insurance contracts) or require the supervisory authority in the Member State of establishment to supervise compliance with the rules of the Member State in which the service is provided. *Commission v Germany*, [1987] 2 CMLR at 104.

71. See id at 102-09.

72. Second Banking Directive at 1 (cited in note 15). See also the Own Funds Directive (cited in note 40) and the Solvency Ratio Directive (cited in note 40).

73. See note 17 for complete citation.

74. UCITS may be structured as investment companies with a corporate form (for example, a *societe d'investissement a capital variable* or SICAV) or unincorporated trusts or funds (for example, a unit trust or a *fonds commun de placement* or FCP) with management companies.

75. Securities issued by a UCITS are referred to in the English text of the UCITS Directive as "units." UCITS Directive at 4 (cited in note 17). Since the term "unit" is intended to cover all forms

UCITS is subject to host Member State control in areas not governed directly by the UCITS Directive, such as marketing. In particular, the Directive permits a UCITS to advertise its units for sale in a host Member State only if the UCITS complies with laws governing advertising in the host Member State.[76] The rationale underlying the host Member State's control of UCITS marketing is that it has the strongest interest in regulating the marketing practices of the UCITS and is in the best position to regulate marketing activities within its borders.[77]

To achieve a basic, harmonized set of investor protection rules, the UCITS Directive establishes a variety of risk-reducing requirements which must be satisfied to qualify any collective investment vehicle as a UCITS.[78] These criteria include limitations on the types of permissible investments for the UCITS,[79] requirements relating to the diversification of investments and limitations on the size of investment in any single venture.[80]

To ensure that the Directive's diversification requirements are not indirectly circumvented and that no duplication of costs or management fees occurs, the Directive prohibits the investment of a UCITS assets in open-end

---

of securities that could be issued by a UCITS, depending on the legal status of a UCITS, units may take a variety of forms, including shares or beneficial interests.

76. See id at arts 44-48.

77. See Proposal for a Council Directive for the coordination of laws, regulations, and administrative provisions regarding collective investment undertaking for transferable securities COM(76)152 final at 10 (April 14, 1976). An additional reason why the UCITS Directive does not include marketing restrictions was the belief that an attempt to coordinate marketing measures in the Member States would have significantly delayed implementation of the Directive. Furthermore, because marketing regulations affect all forms of securities, it was felt that coordination of marketing should be resolved in a more comprehensive manner in a separate directive. Id at 11.

78. The general requirements for categorization as a UCITS are (1) the vehicle must invest in transferable securities that satisfy certain liquidity requirements (that is, they must be "permissible investments"); (2) the vehicle must invest its assets in accordance with certain risk-spreading requirements; and (3) the units issued by the vehicle must, at the request of unitholders, be repurchased or redeemed, directly or indirectly, out of the assets of the vehicle. UCITS Directive at art 1(2) (cited in note 17).

79. UCITS investments are generally limited to transferable securities listed on a recognized stock exchange or another regulated market which "operates regularly and is . . . open to the public." Id at art 19(1). However, the Commission is currently drafting proposals, due out by the end of 1992, which would extend the scope of the directive to include money market funds and funds which invest in other UCITS. Another proposal would extend the directive to real estate funds. See *EC Officials Considering Expansion of UCITS Directive*, 3 EuroWatch 4 (May 8, 1992).

80. In general, a UCITS may not invest more than five percent of its assets in transferable securities issued by the same entity. Member States may raise the five percent limit to a maximum of 10% (with limited exceptions) so long as the total value of all securities held by a UCITS in issuing entities in which it has invested more than five percent of its assets does not exceed 40% of the value of the UCITS. Transferable securities issued and guaranteed by a governmental entity or a public international body and certain mortgage credit bonds or similar public sector debt securities are not included for purposes of applying the 40% limit. Member States may raise the general rule's limit to a maximum of 35% if the transferable securities are issued or guaranteed by a Member State or its local authority, by a non-Member State or by public international bodies, of which one or more Member States are members. Member States may also permit UCITS to invest up to 100% of their assets in such securities so long as (1) the UCITS holds securities from at least six different issues, (2) the securities of any one issue do not account for more than 30% of the UCITS's total assets, and (3) the UCITS complies with certain disclosure and approval requirements relating to information about issuers in whose securities the UCITS intends to invest more than 35% of its assets. See UCITS Directive arts 22-23 (cited in note 17).

mutual funds that do not qualify as UCITS and also prohibits investment of more than five percent of a UCITS' assets in units of other UCITS.[81]

To prevent conflicts of interest, the Directive generally prohibits investment of a UCITS' assets in units of another UCITS under common management or control with it.[82] Similarly, the Directive prohibits investment in the transferable securities of an issuer in amounts sufficient to permit the UCITS to exercise "significant influence" over the management of the issuer.[83]

In addition to imposing risk-reducing requirements,[84] the UCITS Directive seeks to protect unsophisticated investors by establishing basic requirements for the management of UCITS' assets. For example, the UCITS Directive generally requires that the assets of a UCITS be entrusted to a depositary for safekeeping.[85] The depositary must either maintain its registered office in, or be established in, the UCITS' home Member State.[86] In addition, the depositary must be "subject to public control"—that is, to regulation by the competent authorities in the UCITS' home Member State—and have sufficient financial resources both to pursue its business as a depositary and to meet its commitments.

Finally, the UCITS Directive requires each corporate UCITS and each management company of a non-corporate UCITS to publish a prospectus, an annual report, and a half-yearly report. The Directive also establishes detailed disclosure requirements for UCITS prospectuses and periodic reports. As a general matter, sufficient information must be provided to investors to enable them to make an "informed judgment" regarding the UCITS.[87]

B. The Listing Particulars and Prospectus Directives

Two of the most significant Commission directives in the capital markets area are the Listing Particulars Directive[88] and the Prospectus Directive.[89] These directives are intended to facilitate the development of an integrated capital market in the European Community by establishing the principle of

81. Id at art 24. See also note 79.

82. UCITS Directive at art 24(3)-(4) (cited in note 17). But see note 79.

83. Member States may waive this limitation with respect to securities issued by Member States, non-Member States, or public international bodies. Id at art 25(3).

84. See note 77 and accompanying text.

85. UCITS Directive at arts 7(1), 14(1) (cited in note 17). The UCITS Directive provides for two exceptions to this requirement with respect to certain corporate UCITS that market their units through stock exchanges on which they are listed. See id at arts 14(4), 14(5).

86. Id at arts 8(1), 15(1). The home Member State of a UCITS is the Member State in which it is "situated." A UCITS is deemed to be situated in the Member State in which its registered office (or, in the case of an unincorporated UCITS, the registered office of its management company) is located. Id at art 3.

87. Id at art 28.

88. See note 18 for complete citation.

89. Council Directive 89/298, 1989 OJ (L 124/8) (requirements for prospectus when transferable securities are offered to the public) ("Prospectus Directive").

mutual recognition with respect to the various securities disclosure requirements in the Member States.

1. *Listing Particulars Directive.* A prerequisite to the listing of securities on European stock exchanges is publication of a disclosure document, or "listing particulars," relating to the offered securities. The need to satisfy different disclosure requirements of stock exchanges in the various Member States has been a significant barrier to the multiple listing of securities in the Community.[90] The Council took its first step toward eliminating this barrier in 1979 with the adoption of the Admissions Directive,[91] which established a set of minimum criteria that an issuer must satisfy before a security can be listed on an official stock exchange of a Member State.[92]

The Listing Particulars Directive was proposed shortly thereafter and was intended to further the harmonization process begun by the Admissions Directive. The Directive provides that, subject to specified exceptions,[93] stock exchanges must require the publication of listing particulars as a prerequisite to listing. The Listing Particulars Directive established a minimum disclosure standard, setting out the form and content of the information that an issuer must disclose prior to listing.[94] In addition, as originally enacted the Directive called for Member States to "use their best endeavors to achieve maximum coordination of their requirements concerning listing particulars" to facilitate simultaneous applications to several stock exchanges.[95] The

90. A recent empirical study based on data on 481 companies from 10 countries concludes that "reporting requirements constitute a major influence on firms' choices among alternative stock exchanges" in the world and that "firms appear more likely to list where the disclosure requirements are similar to . . . [those of] their own countries." Shahrokh M. Saudagaran, *An Investigation of Selected Factors Influencing Multiple Listing and the Choice of Foreign Stock Exchanges*, in Raj Aggarwal & Cheng-Few Lee, eds, 4B *Advances in Financial Planning and Forecasting* 75, 117 (JAI Press, 1990). In a context closely related to the multiple listing of securities, the International Organization of Securities Commissions ("IOSCO") notes in its comparative review of disclosure requirements in 14 countries that "the differences in financial reporting probably present one of the greatest challenges for issuers seeking to make multinational offerings of securities." IOSCO, *Comparative Analysis of Disclosure Regimes* 4 (IOSCO, 1991).

91. Council Directive 79/279, 1979 OJ (L 66/21) (admission of securities to stock exchange listing) ("Admissions Directive"), as supplemented by Council Directive 82/148, 1982 OJ (L 62).

92. These criteria include a foreseeable market capitalization (of the shares for which admission to official listing is sought) of at least one million ECU and disclosure of financial accounts for the previous three years. Id at Annex Schedule A.

93. Article 1(2) of the Directive provides that the Directive shall not apply to UCITS or to "securities issued by a state or by its regional or local authorities." Listing Particulars Directive at 2 (cited in note 18).

94. The Directive provides detailed minimum disclosure requirements with respect to both financial and non-financial information. Id at Annex Schedules A, B, and C. In addition, subject to the right of the competent authorities in the issuer's home Member State to provide exemptions from the disclosure requirements in certain cases, the Directive requires that listing particulars contain the information necessary "to enable investors and their investment advisors to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer and of the rights attaching to such securities." Id at art 4(1). Article 6 allows the competent authorities in the issuer's home Member State to exempt a variety of securities, including: (1) securities publicly issued in connection with a takeover offer providing that listing particulars had been published in the previous year; (2) securities issued as part of a rights offering or as part of a conversion or exchange; or (3) securities issued by a state-sanctioned monopoly or state enterprise.

95. Id at art 24(1).

Directive permitted Member States to maintain higher standards than those required by the Directive, however, limiting its impact.[96]

The Listing Particulars Directive was substantially revised in 1987 to account for the change in the Commission's focus from harmonization of Community law to the principle of mutual recognition.[97] The revised Listing Particulars Directive incorporates that principle, essentially by providing that when applications for admission to official listing in two or more Member States are made simultaneously or within a "short interval,"[98] listing particulars that satisfy the minimum disclosure requirements of the Listing Particulars Directive and are approved by the appropriate authority in the issuer's home Member State[99] must be recognized by stock exchanges in any other Member State in which listing has been applied for.[100] To serve as listing particulars for the purposes of the Listing Particulars Directive, a prospectus may conform to either the Prospectus Directive or the Listing Particulars Directive.[101]

The mutual recognition regime has significantly reduced Member State barriers to multiple cross-border listings. Host Member State control continues to have an impact in two areas, however. First, Member States may require that listing particulars contain additional information that is specific to the market of the country of admission to listing. Specifically, this information may include local income taxation, the financial organizations retained to act as paying agents for the issuer in that country, and publication of notices to investors.[102] Second, and more importantly, while the Directive requires mutual recognition of listing particulars, it does not require that a specific stock exchange agree to list any specific securities. Competent authorities may still refuse to list a specific security under the Admissions Directive if they deem that "the issuer's situation is such that admission would be detrimental to investor['s] interest."[103]

---

96. See David M. Barnard, *The Effect of 1992 on the Euromarkets*, 630 PLI 603, 635-36 (1989).

97. See June 22 Directive (cited in note 18). The Listing Particulars Directive had been amended previously on March 3, 1982 by Council Directive 82/148, 1982 OJ (L 62). That amendment extended the implementation date of the Listing Particulars Directive (cited in note 18), the Admissions Directive (cited in note 91), and Council Directive 82/121, 1982 OJ (L 48) (publication of information by listed companies) to June 30, 1983 in order to allow Member States to implement all three Directives simultaneously.

98. Although the June 22 Directive itself does not define a "short interval," it mandates recognition by other Member States of prospectuses approved in accordance with the Listing Particulars Directive within the previous three months. June 22 Directive at art 24b(1) (cited in note 18).

99. An issuer's home Member State is the Member State in which the issuer has its registered office. If an issuer's registered office is located outside the Community, the issuer must choose a Member State to serve as its home Member State. Id at art 24.

100. Id at art 24b(1).

101. Article 2(1) of the April 23 Directive (cited in note 18) provides that a prospectus that meets the disclosure requirements of the Listing Particulars Directive and is drawn up and approved in accordance with the Prospectus Directive within the three months preceding an application for admission to official listing shall be accepted as listing particulars.

102. See June 22 Directive at art 24(a)(1) (cited in note 18).

103. See Admissions Directive at art 9(3) (cited in note 91).

2. *Prospectus Directive.* The Prospectus Directive is designed principally to extend the disclosure and, to a lesser extent, the mutual recognition requirements of the Listing Particulars Directive to unlisted securities. Although a Prospectus Directive establishing minimum disclosure standards to govern the sale of unlisted securities had been debated since 1981,[104] it was not until 1989 that the Directive was finally adopted.

The Prospectus Directive mandates that a prospectus be published whenever "transferable securities"[105] are "offered to the public"[106] for the first time in a Member State, if the securities are not already listed on a stock exchange in that Member State. Excluded from the scope of the Directive are a variety of securities, most notably transferable securities that can be acquired for consideration of 40,000 ECU or more. The Prospectus Directive also does not apply to "euro-securities"[107] that are not the subject of a generalized campaign of advertising or canvassing. The purpose of these exceptions is to allow the Prospectus Directive to provide minimum, harmonized disclosure rules to protect the average investor, without subjecting those types of securities that are traded only by large institutional investors to additional, potentially burdensome, regulation.[108]

If transferable securities are to be listed, the disclosure requirements of the Prospectus Directive may be satisfied by listing particulars prepared in accordance with the Listing Particulars Directive, "subject to adaptations appropriate to the circumstances of a public offer."[109] Unlisted securities are governed by the disclosure requirements of article 11 of the Prospective Directive, which are similar to, but less detailed than, those of the Listing Particulars Directive. Alternatively, article 12 enables Member States to allow the issuer of unlisted securities to prepare instead a prospectus in accordance with the Listing Particulars Directive.

The Prospectus Directive incorporates the principle of mutual recognition by providing that a prospectus prepared in accordance with both its requirements and those of the Listing Particulars Directive, and approved by the appropriate authority,[110] can be used in all Member States in which the related securities will be offered simultaneously or within a short interval of

104. The Commission transmitted a proposed Prospectus Directive to the Council on January 13, 1981. On April 23, 1982, the European Parliament endorsed the proposed Prospectus Directive and recommended certain changes to the version proposed to the Council. The Council endorsed an amended proposal for a Prospectus Directive on July 19, 1982, but final adoption was delayed.

105. Transferable securities include equity securities, debt securities with maturities of greater than one year, and any other securities that provide the holder with the right to acquire equity or debt by subscription or exchange. Prospectus Directive at art 3(e) (cited in note 89).

106. The Member States were unable to agree on a common definition of "offer to the public." Id at art 8. See Barnard, 630 PLI at 636-37 (cited in note 96).

107. Euro-securities, as defined by the Prospectus Directive, are securities that are (1) underwritten and distributed by a syndicate composed of firms from more than one Member State; (2) offered on a significant scale in more than one Member State; and (3) subscribed for or initially acquired only through a financial institution. Prospectus Directive at art 3(f) (cited in note 89).

108. Barnard, 630 PLI at 638 (cited in note 96).

109. Prospectus Directive at arts 7, 8(1) (cited in note 89).

110. Normally, the appropriate authority for approval of an issuer's prospectus is the authority in the Member State in which the issuer has its registered office. See id at art 20.

one another.[111] Prospectuses offering unlisted securities need not provide all of the information required by the Listing Particulars Directive, but such prospectuses will not benefit from the mutual recognition provisions of the Prospectus Directive.

IV

CONCLUSION

BALANCING REGULATORY OBJECTIVES WITHIN A MUTUAL RECOGNITION FRAMEWORK

The choice of a regulatory framework for financial services depends on the particular policy goals sought to be achieved. No single framework is optimal to promote the often-conflicting policy goals vying in the financial services sector. Concerns regarding consumer and counterparty protection, safety and soundness, and systemic risk must be balanced against the risk of reducing beneficial competition among international financial service intermediaries through overly restrictive legislation.

A number of different supranational forums in recent years have attempted to decide which principles of international trade best accommodate the regulatory needs of the financial services sector.[112] The United States generally invokes the principle of nondiscrimination or "national treatment" in the financial services sector.[113] Under this approach, a host country seeks to provide "equality of competitive opportunity" with respect to the rights and obligations of domestic and foreign firms within its regulatory structure.[114]

Because of the basic freedoms protected by the Treaty of Rome, Community regulatory initiatives in the financial services sector begin with the premise that Member States should not discriminate against financial service providers from other Member States. The principle of mutual recognition adopted by the Community goes beyond a national treatment approach by

---

111. As with the Listing Particulars Directive, host Member State control continues to have an impact under the Prospectus Directive which allows Member States to require that the prospectus contain additional information specific to the market of the country in which the public offer is made (for example, information regarding the income tax system, the financial organizations retained to act as paying agents for the issuer in that Member State, and publication of notices to investors). Id at art 21(1).

112. Discussions of which international trade principles should govern the financial services sector have occurred during the General Agreement on Tariffs and Trade negotiations at the Uruguay Round and within the Organization for Economic Co-operation and Development. See Sydney J. Key & Hal S. Scott, *International Trade in Banking Services: A Conceptual Framework*, Occasional Papers 35, at 1 (Group of Thirty, 1991).

113. See Dept of Treasury, *National Treatment Study: Report to Congress on Foreign Govt Treatment of U.S. Commercial Banking and Securities Organizations—1986 Update* 1 (1986), cited in Michael J. Levitin, *The Treatment of United States Financial Services Firms in Post-1992 Europe*, 31 Harv Intl L J 507, 518 (1990).

114. Id. The OECD has defined the principle of national treatment somewhat differently: "[T]reatment under host country laws, regulations and administrative practices . . . no less favorable than that accorded in like situations to domestic enterprises." See Key & Scott, Occasional Papers 35 at 8 (cited in note 112).

effectively disadvantaging domestic service providers vis-à-vis competitors from Member States with less restrictive regulation, thereby imposing pressures to converge on a regulatory standard. In a similar vein, the Community's posture with respect to third countries has been to advocate greater host country regulatory liberalization than would result simply from the application of a national treatment approach. Community calls for "reciprocity" in financial services, however, have been taken as threatened protectionism.[115]

These various approaches to international trade in financial services have been analyzed for policy impact in terms of the types of rules on which they primarily rely, whether host country rules, home country rules, or harmonized rules, and the method of providing services—across borders, through branches, and via subsidiaries.[116] For example, the goal of promoting competition is generally best served by home country rules, and thus home country control. The safety and soundness of international financial institutions, on the other hand, are typically best protected by harmonized prudential standards. Finally, certain consumer protection goals are optimally achieved by the imposition of host country rules, such as particular types of disclosure requirements.[117]

In general, the European Community's mutual recognition approach to liberalizing intra-Community trade in financial services should serve to allay the financial sector policy concerns of both home and host Member States. Home country authorization and supervision will lead to increased competition among financial intermediaries in the Community. Ancillary host Member State control will provide necessary consumer and other protections. Harmonized minimum prudential standards will alleviate a number of concerns regarding safety and soundness and systemic risk.

Some aspects of the current Community approach to financial services regulation, however, continue to require further examination and, in some cases, new initiatives. For example, the Council of Ministers has recognized that changes are needed with respect to the consolidated supervision of credit institutions, by adopting a new Consolidated Supervision Directive[118] to clarify which Member State bears the responsibility for leading the supervisory effort. Changes are also warranted to provide clear rights and obligations among supervisors to information necessary for adequate monitoring of solvency and risk.[119] The new Consolidated Supervision

115. In a speech before the Institute of International Economics, Deputy Secretary of the Treasury M. Peter McPherson cautioned that "reciprocity that seeks identical treatment in different countries is a retreat back to protectionism" and that "legitimate differences in national regulatory regimes could be used to justify discrimination against foreign firms." Remarks by M. Peter McPherson, Deputy Secretary of the Treasury, to the Institute for International Economics (Aug 4, 1988), excerpted in Levitin, 31 Harv Intl L J at 522 (cited in note 113).

116. Key & Scott, Occasional Papers 35 at 3 (cited in note 112).

117. Id at 5-6.

118. Consolidated Supervision Directive, Council Directive 92/30, 1992 OJ (L110/52) (repealing Council Directive 83/350, 1983 OJ (L193/18)) ("Consolidated Supervision Directive").

119. See Leon Brittan, *Lessons of BCCI for the Regulators*, Fin Times 11 (July 29, 1991).

Directive would also vest in the Commission authority to negotiate third country agreements regarding consolidated supervision and information-sharing arrangements.[120]

The Commission is also preparing a directive to impose minimum standards of deposit protection throughout the Community.[121] The planned directive would place responsibility for deposit protection on a credit institution's home Member State regulator to reinforce that Member State's primary responsibility for prudential supervision.[122] The planned Directive would seek to protect individual depositors without promoting undue risk-taking by depositors or credit institutions covered by deposit protection arrangements.[123]

Areas of concern remain, however. For example, host Member States lack clear authority under the Second Banking and Investment Services Directives to intervene if the home Member State regulator fails to police adequately the prudential standards for which it is responsible. Moreover, limited financial responsibility for deposit protection may not sufficiently deter lax enforcement.

Finally, serious questions must be addressed regarding competing claims from different Member States on the failure of a Community credit institution or investment firm. Far too little real progress has been made in agreeing upon the appropriate approach to the problem of reconciling different Member States methods of dealing with claims in a winding up, liquidation, or bankruptcy.[124]

The outstanding issues in this area are difficult yet capable of resolution without compromising the mutual recognition principle. As a result, the European Community is poised to gain considerable benefits from competition among its financial service providers and, indirectly, its systems of financial service regulation.

APPENDIX[125]

LIST OF ACTIVITIES SUBJECT TO MUTUAL RECOGNITION

1. Acceptance of deposits and other repayable funds from the public.
2. Lending (including consumer credit, mortgage credit, factoring and financing of commercial transactions).
3. Financial leasing.
4. Money transmission services.

---

120. Consolidated Supervision Directive at art 8 (cited in note 118).

121. Amended Proposal for a Council Directive, COM(88)4 final, (January 4, 1988) (reorganization, winding up, and deposit guarantee schemes) ("Winding-up Directive").

122. Id. See also Roy Goode, *1992: The Insolveny Implications for Banks*, in Cranston, *Single Market* at 146 (cited in note 3).

123. See generally Winding-up Directive (cited in note 121). See also Brittan, Fin Times 11 (cited in note 119).

124. See generally *Single Market* at 146-48 (cited in note 3).

125. See Annex to the Second Banking Directive (cited in note 15).

5. Issuing and administering means of payment (such as credit cards, travellers' cheques, and bankers' drafts).
6. Guarantees and commitments.
7. Trading for own account or for account of customers in (a) money market instruments; (b) foreign exchange; (c) financial futures and options; (d) exchange and interest rate instruments; and (e) transferable securities.
8. Participation in share issues and the provision of services related to such issues.
9. Advice to undertakings on capital structure, industrial strategy and related questions and advice, and services relating to mergers and the purchase of undertakings.
10. Money broking.
11. Portfolio management and advice.
12. Safekeeping and administration of securities.
13. Credit reference services.
14. Safe custody services.