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ESTABLISHING A EUROPEAN SECURITIES REGULATOR:

Is the European Union an Optimal Economic Area for a Single Securities Regulator?

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Abstract

The paper's purpose is to address the economic, institutional, and legal issues confronting the establishment of a more centralised approach to EU securities regulation and to suggest that the theory of optimum currency areas can be used as a model to assess the economic benefits and costs of further centralisation of securities regulation in the European Union. The European Union's Financial Services Action Plan seeks to achieve an integrated market in financial services in order to accomplish the economic and political objectives of the Treaty of Rome. The FSAP is premised on the notion that the adoption of legal and regulatory measures to achieve liberalisation in cross-border trade in financial services will also achieve integration of EU financial markets. This paper argues that *liberalisation* of financial markets does not *necessarily* lead to *integration* of financial markets. Furthermore, it argues that the institutional design and scope of financial regulation should be based, in part, on the extent of integration in the financial market. That is, the domain of the regulator should be the same as the domain of the market. European capital and financial markets remain fragmented and segmented. This paper argues therefore that, until EU financial markets become more integrated, a single EU securities regulator would not be an efficient or effective institutional model for EU securities markets. In other words, at present, the EU is not an optimal economic area for a single securities regulator.

Keywords:

European Community Law, International economic order, international financial markets, regulation, cross-border securities trading,

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K22, F02, G15, L51, K33

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Introduction

For forms of Government let fools contest
Whatever is best administered is best
Alexander Pope

European financial markets are rapidly evolving in response to the forces of technological change, deregulation and liberalisation. They remain fragmented and segmented in many areas, however. Although interest rate differentials have substantially converged in the interbank markets, the capital markets remain essentially segmented within national jurisdictions, whilst very little cross-border activity takes place in corporate loans and in banking services. The composition of most investment funds is substantially biased towards home markets. Although some of the fragmentation may be attributed to regulatory obstacles and legal barriers, the major causes have more to do with macroeconomic, social and cultural factors. For instance, differences in the risk appetite of investors across jurisdictions affect the types of investment products offered, whilst market imperfections often result in major obstacles to the efficient flow of capital throughout the EU. This paper argues that the market structure factors are largely independent of the regulatory and legal barriers that are generally viewed as the major obstacles to achieving a single EU market in financial services.

The role of EU institutions in regulating financial markets is also undergoing significant change, as various legislative and institutional initiatives have rapidly changed the European Union's regulatory structure for monetary policy, payment systems, and financial services. For example, the European Central Bank exercises primary authority over monetary policy and payment system regulation in the eurozone and is accountable to EU finance ministers and the Parliament.[1] In investment services and securities, the Lamfalussy Committee's recommendations were recognised by the Council of Ministers' Stockholm Resolution of March 2001[2] as providing a programme that creates a new four-level consolidated regulatory approach to make the EU securities legislation process more efficient, flexible, and transparent.[3] The European Union's Financial Services Action Plan ('FSAP') has recognised the Lamfalussy programme as an essential element to achieving the EU Treaty objectives of an internal market for capital movement and trade in financial services.[4] The Lamfalussy programme is essentially a regulatory process that relies on existing comitology procedures as set forth in Article 202 of the Treaty of Rome to develop EU securities legislation based on proposals from national finance ministers and regulators and in consultation with industry.

The institutional structure of the Lamfalussy programme has been criticised as being too slow and subject to protectionist influences from national authorities.[5] It is argued that these weaknesses are obstacles to achieving the objectives of the EU Financial Services Action Plan (FSAP), thereby justifying the creation of a single EU securities regulator. This paper argues that advocates of increased centralisation of EU securities regulation have not given adequate thought as to whether EU economies (including accession country economies) have achieved sufficient levels of convergence and integration in their financial market structures and practices to justify increased centralisation and consolidation of securities regulation at the EU level. Indeed, the lack of integration between EU financial markets, especially in equities and retail financial services, suggests that the European Union (including the accession countries) may not be an optimal economic area for a single securities regulator. This paper builds on previous research to argue that the institutional design and scope of a financial regulator should depend, in part, on the extent of integration in the financial market over which it regulates. In other words, the *domain of the regulator* should be the same as the *domain of the market*.[6] The domain of a financial market can be determined, in part, by its degree of integration.

This paper draws on preliminary financial market data to suggest that the lack of integration in EU securities markets militates against further centralisation and consolidation of the institutional structure of EU securities and investment services regulation. In fact, more prosaically, the paper asserts that the low level of integration in most areas of EU financial and investment services markets suggests that the EU may not be an optimal economic area for a single securities regulator.[7] Any final conclusions regarding the extent of financial integration will remain preliminary until further research has been undertaken to measure, in a more precise manner, the actual degree of financial integration in the European Union.[8] The paper also attempts to undermine one of the major premises of the EU FSAP, which is that there is a necessary relationship between the degree of liberalisation and regulatory harmonisation in financial markets *and* the degree of integration of those markets. The EU FSAP presumes that by reducing or eliminating regulatory and legal barriers to cross-border trade in financial services that financial market integration will logically follow. The FSAP approach, however, fails to make the important distinction between the creation of a liberalised framework of financial regulation *and* the creation of truly integrated financial markets. Similarly, those advocates of a single securities regulator have also failed to address this problem of distinguishing between integration and liberalisation and the implication of this for the success of EU regulatory integration programmes.

Notwithstanding the lack of integration in EU financial markets, the ultimate objectives of the EU Treaties to create a seamless internal market for trade in goods, services, and capital requires a certain degree of EU regulatory authority *both* in terms of institutional design and in harmonised standards and principles. Indeed, the institutional design of financial regulation should be flexible and always responsive to developments in financial markets. At the present stage of EU financial development, EU regulatory authorities should be involved in devising high-level principles that should take account of national differences in segmented EU financial markets. Indeed, the paper suggests that broad principles devised at the EU level should be implemented by national authorities who would adopt national rules that respect the economic, institutional, and legal differences between EU countries. Indeed, further efforts that go beyond the Lamfalussy framework which do not take account of further integration in EU financial markets might potentially undermine financial development and reduce the overall efficiency of EU capital markets.

The paper will also evaluate the various institutional models for explaining how the Lamfalussy programme has produced a rapid consolidation of European Community regulatory powers. Although the Lamfalussy programme speeds up and consolidates regulatory decisionmaking through enhanced comitology powers, it is essentially a regulatory process that does not necessarily involve substantive harmonisation of EU securities legislation, and therefore is not a significant departure from traditional notions of inter-governmental coordination in EU policymaking. Although the early stages of implementation of the Lamfalussy programme have ignited much controversy concerning the scope of legislative authority for Community institutions, Lamfalussy streamlines decision-making and requires consultation and transparency and does not undermine the vital role that national regulators and market participants play in regulating securities markets.

This paper contains five parts. Part I discusses the nature of financial market integration and the liberalisation of regulatory controls in the European Union. Part II analyses the economic rationale for securities regulation and sets forth some of the criteria for determining whether additional consolidation of regulatory powers at the EU level would promote the efficient development of EU securities markets. Indeed, it argues that because the EU may not yet be an optimum economic area for a single regulator that further consolidation and centralisation could potentially undermine economic growth and hinder the efficient development of EU securities markets. Although certain efficiencies can be gained by adopting a more centralised EU approach, existing structural differences in EU financial markets and different market practices and legal systems militate against increased centralisation of securities regulation.

Part III generally describes the existing institutional structure and regulatory principles governing EU financial supervision and regulation. Part IV generally describes the Lamfalussy programme and assesses whether its regulatory framework and institutional structure can achieve the economic objectives of efficiency and institutional accountability. Although the section points out the positive effects of establishing a more centralised EU process for devising securities legislation, it suggests that efficient regulation of EU securities markets requires a EU supervisory framework whereby high level principles are adopted at the EU level (based on member state proposals and industry consultation) but more specific rules and codes are devised and implemented by national authorities. Such a structure would address the need to have general principles of good governance in EU markets, whilst recognising that implementation of such principles must take account of differences amongst member states in institutional and economic structures.[9] This approach is especially important for the efficient integration of the accession countries' financial markets into the EU regulatory framework.

Part V examines the principles of institutional design in the European Community and suggests that the Lamfalussy programme represents a continuing trend in EU economic regulation whereby inter-governmental negotiations and bargaining produce an institutional and policymaking process that respects EU constitutional principles, yet proves adaptable and flexible enough to address the specific economic challenges posed by increasing liberalisation and deregulation in financial markets. Part VI evaluates the crucial issue of whether the European Union qualifies as an optimum economic area for securities regulation. The theoretical basis for determining optimum economic areas derives from Merton's criteria for optimum currency areas. I apply these principles, with some modification, with respect to cross-border trading in securities and financial services. This section analyses some of the theories of financial market integration and provides a preliminary assessment of various measures of market integration. The section discusses the issue of whether the economic rationale for a more centralised EU securities regulation regime has been properly thought out and the threat a single regulatory regime may pose to the efficient development of EU securities markets.

The paper's main policy recommendation holds that as long as EU securities markets remain highly segmented and fragmented along national jurisdictional lines, securities regulation should remain primarily nationally-based. EU institutional structures and high level principles, however, have a role to play in promoting the Treaty objective of an internal market while ensuring that the goal of financial integration is ultimately achieved. This means that further centralisation and consolidation of EU securities regulation that goes beyond the Lamfalussy framework could potentially undermine EU financial development and economic growth. Alternatively, the task for policymakers could involve implementing the Lamfalaussy programme in a manner that fosters competition in regulation practices amongst national bodies so that a more organic, economically induced regulatory regime emerges to govern EU securities markets.

I. EU financial markets and the extent of integration

EU securities markets are of major importance in performing the function of raising and promoting the raising of capital that generates economic growth and development. The main components of the EU capital markets consist of financial activity in bonds, equities, syndicated loans, derivatives trading, euro commercial paper, medium-term euro-note programmes. Euro bonds constitute the largest portion of total issues. Dramatic growth and innovation in international bond markets and cross-border trading in equities has had a tremendous impact on EU financial markets.

Equity markets have played a particularly important role in raising capital and providing liquidity for EU capital markets. Equity markets include publicly listed companies on stock exchanges that provide investors with prescribed levels of disclosure that enable the efficient pricing of securities, along with the 'off-market' work of venture capital firms that are willing to assume higher levels of risk for higher, but more speculative, returns. More generally, securities markets involve equity and debt offerings with a similarly high range of risk tolerance. The financial systems of many countries in the European Union, however, have relied relatively less on capital markets (for both equities and bonds) *vis-à-vis* bank finance. For instance, corporate finance in Germany has placed much greater emphasis on bank lending to supply capital needs, whereas equity capital has been a much more important source of finance for UK and Irish companies. Some jurisdictions, like the US and UK, restrict the level of bank finance for listed companies based on strict statutory and regulatory requirements.

Most experts agree that integration of EU equity markets is at a relatively undeveloped stage, whereas euro bond, foreign exchange and wholesale bank lending markets are more integrated.[10] Equity markets will play an increasing role in capital formation and in cross-border trading in collateral interests in securities.[11] Equity markets will also remain a primary focus of regulators in devising regulations to liberalise cross-border trading in securities, and in many cases the regulations written for securities have also been applied to the corporate debt and commodities markets.(McCleskey, 2003).

Integration in EU financial markets

A truly integrated EU financial services market would ideally involve the following factors. Investors would be able to invest in instruments issued and traded in other member states without regulatory impediments. Intermediaries would have the ability to transact freely with clients in other member states on the same terms and conditions as local businesses. Issuers would have access to deeper and more liquid markets with lower bid-ask spreads and reduced transaction costs and capital costs. For clearing and settlement, infrastructure suppliers would provide access to their facilities to all market participants and users across the EU. And regulators and supervisors would have the ability to prosecute cross-border transactions that involve violations of EU or member state financial regulations, and to undertake investigations and enforcement actions in an effective and speedy manner so as to deter future misconduct.

Such truly integrated financial markets would create benefits in terms of enhanced market liquidity, and more efficient allocation of investment resources. The lower cost of capital would lead to increased investment. Higher returns on private savings for small investors, pension funds and other collective investment schemes would help defuse Europe's looming pension crisis. Increased integration would make more venture capital available for higher risk investment projects and firms; this would lead to enhanced financial innovation and further development of the high risk small and medium enterprise sector.[12]

In some areas, EU financial markets have shown high levels of integration relative to other areas. For instance, banks have direct access to central bank liquidity in the eurozone which has supported the creation of a fully integrated money market for interbank liquidity transfers.[13] For banks that are active participants in the euro interbank market,[14] the data show that overnight lending rates have narrowed substantially since 1999 across banks in all eurozone jurisdictions as overnight rates have fallen to around two basis points.[15] Another area of rapid integration is the repo market where liquidity (*de facto* loans) is exchanged against collateral. Less integration exists for eurozone banks that make unsecured loans to other sophisticated counterparties in different EU jurisdictions because of higher levels of credit risk and the need to monitor the creditworthiness of foreign counterparties (Holthausen & Freixas, 2001). It should be noted that the extent of integration will also depend on the degree of cross-border cooperation and coordination between supervisors in obtaining information on cross-border parties and how much of this information is made available to market participants.

By contrast, European Union securities and investment services markets exhibit significantly lower levels of integration and are generally viewed as fragmented in comparison with US markets.(Lamfalussy *et al*., 2001). Capital formation is essentially segmented within national jurisdictions, while very little cross-border activity takes place in the life insurance, pensions business and other retail sectors. Although some of the fragmentation may be attributed to regulatory obstacles, the major causes have more to do with fundamental structural and cultural factors.(McCleskey, 2003). For instance, differences in taxation deter cross-border sale and branch activity in both wholesale and retail markets. Different investor preferences have resulted in different appetites for risk in financial products across jurisdictions.

II. The Economic Rationale For European Securities Regulation

This section presents the economic rationale for financial regulation and weighs the economic advantages and disadvantages of regulating EU securities markets.

The rationale for economic and financial regulation

The normative theory of regulation holds that public regulation of economic activity is only justified to remedy market failure, that is, when the market is incapable of producing a social or Pareto optimum. Market failure can take many forms, but most prominently it occurs in cases of monopoly, imperfect information, and negative externalities. According to this view, regulation should only be used to correct market failures, and not for other social purposes, such as income redistribution.

In contrast, another major theory of regulation is the positive theory (Stigler 1970), which holds that regulation is not adopted for the protection and benefit of the public at large, but is designed and implemented primarily for the benefit of special interest groups (ie., industries subject to the regulation). The positive theory of regulation has been elaborated upon by Posner (1974) and Becker (1983) and will be discussed further below.

Generally, financial regulation has several main objectives. (1) to minimise systemic risk so that financial instruments are priced to cover the costs of the risk they pose to the broader economy. The efficient pricing of risk in financial markets will avoid the situation where the collapse of one bank or large financial firm causes the collapse of other financial institutions, which may lead to a domino effect resulting in the collapse of the entire financial system. (2) To enhance competition so that financial institutions allocate capital in a manner that promotes efficient risk taking and competitive prices for financial products. (3) Investor protection so that asymmetries of information are minimised to promote equality of investment opportunities and adequate remedies for losses incurred because of market abuse or financial crime. (4) To promote the overall efficiency and integrity of capital markets so that investors have a high degree of confidence in the system. Indeed, financial regulation that is based on these objectives can provide significant benefits that enable societies to operate in a more efficient and humane way.

In assessing the benefits of securities regulation, Easterbrook and Fischel have argued that no valid evidence exists to show that disclosure rules directed against fraud and market manipulation produce any economic benefits.[16] The better view, however, justifies disclosure requirements in securities regulations on the basis that they reduce asymmetries of information between investors and issuers, thereby promoting improved risk evaluation and efficient pricing of securities. Moreover, ensuring that market participants adhere to disclosure rules requires an effective enforcement mechanism to deter financial misconduct, such as fraud and market abuse. In addition, the problem of legal risk arises where specific laws are uncertain in regulating particular transactions. Indeed, legal uncertainty results in higher social costs to the extent that businesses and other economic actors require detailed legal opinions before entering into transactions. Where it is necessary to reduce legal uncertainty so as to reduce regulatory compliance costs, it demonstrates that in some situations more regulation (at least in disclosure and transparency) can reduce economic costs and therefore be preferable to less.

Direct and indirect costs of regulation

Advocates of regulatory reform often over-emphasise the perceived benefits at the expense of the social costs created. Indeed, Coase noted that when divergences occurred between private and social product, too much emphasis was placed on the specific deficiency that had created the externality, which often resulted in the view that any governmental or regulatory measure to eliminate the externality was desirable.(Coase 1960, p. 43). The regulatory intervention often 'diverts attention from those other changes in the system which are inevitably associated with the corrective measure, changes which may well produce more harm than the original deficiency'.[17] The regulatory debate often fails to take account of the costs, direct and indirect, of any reform proposals. Some of the more obvious costs in securities regulation include the administrative burden of complying with regulatory requirements and in particular disclosing specific information and due diligence reports. This involves complying with authorisation standards, licence fees and other charges, capitalisation and reserve requirements. As mentioned above, there are also indirect costs that may arise from legal uncertainty, which may bear directly on economic activity that includes 'opportunity costs', 'transaction costs', and 'compliance costs'.

Regulations may adversely affect consumers by imposing higher prices for goods and services, and result in reduced consumer choice and lower quality goods and services. For both investors and issuing companies, excessive or inefficient securities regulation can result in higher costs for capital. Government also increases costs for itself through adopting new regulatory processes and requirements: the number and level of staffing, salary costs, the costs of surveillance and enforcement impose costs on taxpayers and thus may constrain economic growth. Indeed, securities regulatory requirements may result in lost opportunities or misallocation of resources.

Although regulation of securities markets can enhance liquidity and efficiency in resource allocation, it can also create unreasonable obstacles and barriers to trade in financial services that may impede cross-borders efficiencies by deterring foreign investors and issuers. Indeed, restrictive trade barriers may lead to reduced investor opportunities and thereby drive 'riskier' investments from the markets.[18] This might explain why securities underwriters are less willing to take certain high-risk securities to market if they face greater potential legal liability. This would result in investors having access to fewer possible investment opportunities, whereas in the absence of such regulation, the investors would have merely expected a higher compensation for investing in risky securities. National economic growth might also be undermined because enterprises involved in riskier behaviour could have less funds available to finance new ventures.

Indirect costs of regulation arise from lost opportunities in relation to innovation and optimally negotiated outcomes. One view holds that regulators should refrain from prescribing market outcomes unless it is absolutely necessary to do so. This can be demonstrated in the area of prospectus requirements where the regulatory policy underlying the capital raising provisions of company law is that of protecting investors by endeavouring to ensure that all information relevant to the making of an informed investment decision has been provided regarding any invitation or offer of securities. One rationale for prospectus requirements is that the costs involved in making regulatory disclosures would still be incurred even if the law did not exist, because investors would require the company to undertake similar exercise before they would be willing to invest in the company. This assertion raises a number of questions, such as would certain investors require less rigorous disclosure or, indeed, none at all? Is there an equitable rationale for requiring a company to disclose voluminous information to professional investors who would hardly be described as vulnerable members of society? Perhaps, in a diversified market of retail and professional investors, information disclosure requirements should be tailored to the needs of the investor and while this may mean, in certain circumstances, that the costs of disclosing to investors are the same as what would be incurred under the current regulations, it may also result in less total cost as some investors require less disclosure to make an informed investment. Similarly, it may also result in less total costs for some investors who may only focus on certain parts of information already disclosed.

In most EU jurisdictions, securities regulation does not permit such an option for the company and investor to agree to a lower cost method of prospectus disclosure. Indeed, under existing EU securities regulation, there is little or no recognition that the higher risk profile of low disclosing companies will discourage investment in those companies. According to this view, unresponsive investors to low-disclosing and high-risk companies would create a powerful incentive for these companies to provide more disclosure. When regulators attempt to prescribe a certain level of disclosure, they often achieve sub-optimal outcomes and discourage future, efficient behaviour.

In addition, it is also difficult for regulators to respond to rapid changes of behaviour and sentiment in the marketplace. Indeed, much of commerce involves the acquisition of information through repeat transactions, which may lead buyers and sellers to adopt a joint welfare maximising strategy in which they agree to cooperate and provide information necessary to enhance their returns. This view raises the important issue of whether regulations should force a company to disclose information which is not necessary, based on the parties' requirements, for the transaction to proceed. The opposing view to this position is that the relaxation of prospectus requirements will permit abuse of the innocent investor by a large, unscrupulous company.[19]

Industry Consultation

Any EU securities regulatory regime and its accompanying institutional structure should recognise the views of market participants. It is true that market participants rarely share common views on any one issue, but they do serve as an acceptable source of empirical information that is often more reliable than theoretical or ideological arguments advocating particular regulatory structures. Indeed, many experts have recognised that, because financial markets are rapidly changing, that market participants often have an advantage in assessing the impact of regulatory controls on market behaviour, and their views should be taken into account when formulating regulatory rules.

This perspective, however, can be criticised for being too narrowly focused on transacting parties, while giving little weight to the externalities that may affect third parties and also to broader societal goals. Nevertheless, a compelling argument can be made that the views of market participants should take precedence, rather than the views of regulators and experts. Some observers have even raised the issue in such a way that if a regulator or policymakers identify the need for a regulatory reform because it might protect market participants, yet market participants strenuously oppose such reform, it may well be advised to consider, at length, why there is a gap between the theory of regulatory practice and the desires of market participants.[20] The question arises why the regulators are proposing reforms that will have a deleterious effect? Is it because of information asymmetry? Do the regulators have different access to market information or simply not able to discern the relevant information. Are special interests groups addressing the true deficiencies affecting the market? Should market participants be given a role in influencing whether regulations should take effect? More broadly, should the goal of securities regulation be to lessen the impediments to privately-negotiated market outcomes?

The above discussion suggests that regulation prevents, or at least hinders, innovation and adaptation. Regulation should foster decision-making that emphasises choices over time, rather than leaving to experts the authority to determine the right way to perform transactions. The securities markets of many EU member states, and most particularly of the accession states, are undeveloped and need robust and flexible regulatory standards to promote economic growth on a permanent basis. The OECD has noted that company creation and growth and vibrant capital markets in the European Community depend on low compliance costs in the areas of taxation and securities regulation.[21]

Cost-benefit analysis of EU securities regulation

Regulation exists not only in the interest of investors but also in the interests of business enterprises that seek to raise capital. When members of the public are offered the opportunity to invest in intangible property claims, it is generally agreed that there should be disclosure by the persons making the offers.[22] Disclosure is necessary in the primary market for securities, as well as in the secondary market where securities have already been issued and are traded. Also, the availability of capital for business endeavours requires confidence by the investing public in the honesty and efficiency of securities markets and in the individuals who carry out transactions in securities. Securities should not be seen as merely a set of restrictions on market behaviour, but also as facilitative of securities trading and capital formation.

Any evaluation of whether the EU is constructing an optimal securities regulation regime must take account of an economic framework that examines the purported benefits of securities regulation and balances it against the costs associated with adopting the regime that will be incurred by market participants and the regulatory authority. This type of cost-benefit analysis is an important aspect of the law and economics approach to economic regulation. It utilises economic analysis to predict and test both the allocative and distributive impact of alternative legal regimes of regulation, and provides indispensable insights into the implications of regulatory policy choices. Although there is a substantial and growing body of economic, legal and philosophical literature that generally criticises the law and economics approach, the economics profession has recently utilised various analytical and empirical techniques to provide some useful insights on the regulatory debate (Deakin 1999).[23]

Empirical data is needed to obtain a better understanding of the relationship of how laws affect economic behaviour. There are many ways in which the efficacy of securities regulation can be evaluated, whilst there are several methodologies by which the application and implementation of regulations can be optimised. Economic analysis can involve a number of principles and methods to ascertain optimal levels of regulation, including 'regulatory cost-benefit analysis', 'opportunity costs', macroeconomics, and efficient breach and enforcement.[24] An assessment of the net regulatory burden of securities regulation for any jurisdiction should take account of *both* costs and benefits. This involves comparing the incremental costs incurred less the marginal benefits realised from the adopted regulation. A cost-benefit analysis would involve a thorough examination of whether market freedom should be curtailed based on clear regulatory objectives and whether the benefits of market intervention outweigh the costs. Many economists argue, however, that applying a cost-benefit analysis involves inherently subjective criteria and vague measures that can only estimate with a wide margin of error what the true costs and benefits of regulation are.[25]

III. EUROPEAN COMMUNITY PRINCIPLES FOR FINANCIAL REGULATION, SUPERVISION AND POLICY-MAKING –

This section provides an overview of EU principles of regulation and supervision and the general legal framework governing financial regulation and whether it has achieved market integration. The primary legal basis for the creation of an internal and integrated market for capital and financial services is found in the Treaty of Rome of 1957, as amended, which established the European Community. The Treaty set forth the four essential freedoms – free movement of goods, services, persons, and capital[26] - for the creation of an internal free market in the European Community. The four freedoms were the legal instruments to achieve the economic objective of an internal European market. The prerequisites for the internal European market were the removal of trade barriers, establishment of a customs union, and eventually a common, internal market.[27] Some scholars have noted, however, that the economic objectives of the Treaty and subsequent EU legislation are mere instruments of political integration.(Wallace & Wallace, 2000 & McCleskey, 2003). Therefore, much of the economic policy-making that drives the EU internal market programme can possibly be called into question on economic efficiency grounds because of its over-riding political dimension.

EU Legal and Regulatory Principles

The supervisory framework for banking and financial services within the European Union's internal market relies primarily on the principles of home country control and minimum harmonization. (Andenas & Avgerinos, 2003)[28] According to the principle of home country control, regulatory authority over banks and investment firms that conduct activities through their branches in other member states lies with the competent authorities in the state where the institution's head office is located. According to the principle of minimum harmonization, member states are required to harmonise what are considered the essential areas of financial regulation while being free to surpass EU minimum standards and to maintain national regulation in areas not harmonised. The minimum standards to be incorporated in national regulation by all member states were established in directives issued by the EC Council.[29]

EC regulation does not prescribe the type of banking or securities trading system a member country must have. Rather, each member state continues to develop its traditional banking system under the impact of increasing competition in the European market. For instance, under the EC Banking Directives, the same type of activity will be subject to the same prudential rules (ie., Capital Adequacy Directive), whether it is undertaken by a universal bank, an investment bank, or another specialized bank.[30] Similarly, EU directives do not require a particular institutional structure of financial supervision. Regulatory responsibilities may be allocated according to types of institutions or tasks. But a state seeking to join the European Union must demonstrate that it has complied with a fixed set of rules and regulations, which include legislative implementation of all relevant EU directives and regulations on financial regulation. For example, a member state must allow a investment firm incorporated in another member state complete access to its market. It must recognise the regulatory and supervisory standards of the EU state which serves as the home country of the firm seeking access to its market. In contrast, a host EU state may resort to case-by-case negotiations with a non-EU state before it agrees market access to a non-EU financial firm based in a non-EU state.

Mutual recognition rules are based on common objectives and can only work effectively if regulators have confidence in the standards of other member state regulators. The advantage of mutual recognition is that it generates a competitive process of regulation that may lead eventually (in theory) to convergence of regulatory standards. Mutual recognition based on home country rules has been praised as producing common EU standard more quickly than if host country rules had applied. Generally, the home country principle has functioned effectively in integrating EU markets, but further harmonisation of standards can be expected as a result of market forces and increasing pressures from national and EU governments. This will result in reduced powers for host countries to restrict cross-border trade in investment services through the use of notification procedures and the general good principle.[31] Some experts assert that the home country control principle will become less effective in the future as large financial groups increase their operations in the EU market by establishing home operations in more than one jurisdiction.[32] Accordingly, some experts have raised the issue of whether the EU itself should be a home market? (Lanoo, 2002).

Although these regulatory and legal principles have provided a sound basis for achieving some of the objectives of the internal market for capital and financial services, many regulatory and policy gaps remain and EU financial services markets continue to be significantly segmented along member state boundaries. EC Commission officials argue that existing directives and regulations, along with the principle of home country control and mutual recognition based on the equivalence of member state regulation, have been overtaken by market developments and that obstacles to market integration can only be eliminated by adopting a more harmonised regulatory and legal framework combined with a more consolidated, centralised institutional structure of financial regulation.[33] At present, cross-border provision of financial services confronts a number of national regulatory and legal barriers. Although the Second Banking Directive and the Investment Services Directive have facilitated cross-border establishment of firms, the remote provision of financial services is still strictly limited by most host countries based on 'general good' rules. Moreover, much uncertainty remains regarding the treatment of new types of business, such as execution only trading services and alternative trading services (ATSs). Cross-border capital raising requires adherence to host country rules with the result that there are few examples of multiple listings because of the complexity and high costs. In addition to legal and regulatory barriers, many economic, social and cultural barriers have obstructed cross-border trade in financial services.

EU Financial Services Action Plan (FSAP)

In 1999, the European Commission proposed the Financial Services Action Plan (FSAP),[34] which constitutes the agenda for achieving an integrated European market in financial services. The FSAP proposes priorities and time-scales for legislative and other regulatory measures aimed at four strategic objectives: (1) a single market for wholesale financial services, (2) open and secure retail markets, (3) modernised prudential rules and supervision of intermediaries and securities firms, and (4) improved conditions for an optimal single financial market. The FSAP contains 42 measures to achieve these objectives that have been updated over time to take account of evolving challenges in the market, such as institutions becoming organised on a pan-European or cross-sectoral basis, and major corporate and financial frauds (ie., Enron & WorldCom). Some of the more significant of these legislative measures have taken the form of directives that provide uniform EU requirements for admission to trading and prospectuses for public offers (Prospectus Directive), transparency in periodic reporting of issuers (Transparency

Directive), rules on ad hoc disclosure of price sensitive information (Market Abuse Directive), and imposing admission requirements for free negotiability of instruments on 'regulated markets' (Investment Services Directive).

The FSAP agenda for increasing market integration in securities and investment services envisions investors being able to raise capital throughout the EU, and instruments being tradable across the EU. It also seeks to achieve a centralised infrastructure for the finalisation of financial transactions, such as clearing and settlement, and the development of prudential rules in this area. Investors should face seamless capital markets into which they can place and withdraw their investments and profits. The FSAP envisions adoption of the securities and investment legislative measures by December 2003. Obstacles remain, however, regarding the takeover directive and international accounting standards.

The FSAP has set forth an elaborate new regulatory and legal framework to create a more harmonised EU regulatory regime. It also seeks to narrow the general good exception rules that have previously allowed host countries to maintain protectionist regulatory policies against foreign service providers. The FSAP has adopted an ambitious programme to harmonise and liberalise EU trade in financial services and capital markets. The FSAP is premised on the view that the adoption of legal and regulatory instruments (42 FSAP measures) that require a more harmonised and liberalised capital and financial markets will necessarily lead to true integration of EU financial markets. This paper contests this premise by asserting that liberalisation of capital and financial markets will not inevitably lead to integration of financial markets. To achieve true integration, EU and national regulators must address macroeconomic distortions and market failures, and social and cultural factors that pose the major the problem in Europe's financial markets remain fragmented and segmented. Despite the FSAPs focus on regulatory and legal barriers, data suggests and economic theory holds that other obstacles, such as market failure, differences in taxation and heterogeneous investor preferences are the chief factors in keeping Europe's financial markets fragmented and segmented.

IV. EU Securities Regulation and the Lamfalussy Programme

The European Council recognised the Lamfalussy Report in March 2001 at the Stockholm Council meeting as the basis from which a new enhanced comitology procedure would be established containing a four-level approach for proposing, adopting and implementing EU securities legislation. The four-levels are composed of essential principles, implementing measures, co-operation, and enforcement.[35] It should be noted that the Lamfalussy programme is primarily concerned with regulatory process, and not necessarily with the harmonisation of EU securities regulation throughout the Union. Pursuant to the Lamfalussy programme, the Commission created in June 2001 a European Securities Committee (ESC) and a Committee of European Securities Regulators (CESR).[36]

The ongoing implementation of the Lamfalussy programme is providing the Commission, in conjunction with the ESC and CESR, with increased authority to develop the relevant legislative and regulatory tools to respond to the rapidly changing cross-border nature of European securities markets. In this process, the EU ministers of finance, who compose the ECOFIN Council, are jointly responsible with the Parliament for approving the directives, while they are individually responsible for ensuring consistency between European legislation and national regulation.[37]

European Securities Committee (ESC)

The Commission Decision of 6 June 2001[38] established the European Securities Committee (ESC), which replaced the High Level Securities Supervisors Committee (HLSSC).[39] The ESC was established to act in a regulatory capacity, within the framework of the Comitology Decision of 1999.[40] The ESC plays the main role in the four-level regulatory approach to expedite the regulatory process for EU securities regulation and to make it more flexible and efficient.[41] Level 1 refers to EU framework legislation and essential measures, which will be adopted by the standard co-decision procedure by the Council and the Parliament. These two bodies will also agree on the nature and extent of the implementing measures to be decided at Level 2 on the basis of Commission proposals. Level 2 refers to EU implementation and the non-essential measures, which will be defined, proposed and adopted, in application of the Comitology

Decision, by the Commission and the ESC, while the Committee of European Securities Regulators (CESR) will act in an advisory capacity. Level 3 refers to strengthened cooperation between regulators to improve implementation, which will be designed to improve consistency of day-to-day transposition and implementation of Levels 1 and 2 legislation. This stage involves the Member States and the CESR. Finally, Level 4 refers to enforcement and involves the Commission and the Member States.

Although the new legislative structure is believed to respond to the need for speed, efficiency and flexibility in securities regulation,[42] some have criticised it for creating more problems than it was meant to solve. Mutual suspicion among national and European institutions has complicated the enactment of financial legislation in the EU. In particular, the Parliament has expressed concerns and has voted in favour of a "call back" procedure that would enable it to review and halt legislation proposed at Level 2. The Parliament adopted a "sunset clause" that will terminate the ESC four years after the entry into force of the directives creating it (2005), unless its powers are redefined by a new Commission proposal that is approved by the Parliament and the Council.[43]

The Parliament's concerns are also shared by market participants, the securities industry and experts who criticise Level 2 implementing procedures as lacking transparency. The financial sector would prefer more direct consultation and transparency at the Level 2 implementing stage, especially in view of the accelerating changes occurring in European financial markets.[44] Other important issues concern how to distinguish between the essential statutory measures of Level 1 and the implementing measures of Level 2. Or, more precisely, what is to be decided by the normal co-decision procedure of the Council and the Parliament and what should be delegated to the Commission and the ESC? The Lamfalussy Report has failed to give sufficient guidance on this issue, but the success of the new regime will heavily depend on the clear definition and distinction between essential and non-essential measures (Avgerinos, 2003)(Lenaerts, 1993).[45]

The Committee of European Securities Regulators (CESR)

Following the suggestions of the Lamfalussy Report, the Committee of European Securities Regulators was established.[46] CESR comprises the securities commissions of the EEA countries. Its role is to act as an independent advisory group to assist the Commission in particular in its preparation of Level 2 draft implementing measures. At this level, as in its Level 3 role, the CESR consults extensively in an open and transparent manner, fully involving market participants, consumers and end-users. The aim is to achieve a balance between effective consultation and efficient use of the limited resources devoted by all interested parties in the regulatory issues in the securities field. It also attempts to balance effective consultation with the fact that, at Level 2, the Committee will be constrained by the scope and timetable of the mandates given to it by the European Commission. All those involved in the consultation process will need to "play a co-operative game", in other words, to work in a manner that promotes the success of the process.[47]

CESR organises its own operational arrangements.[48] The costs relating to the administration of the CESR is borne entirely by the national supervisory authorities comprising the membership of the committee. Significantly, the Commission plays a key role in CESR's procedures, as it does with the ESC, by providing mandates to CESR to address certain issues within certain time limits. The Commission also informs CESR of political priorities, while contributing to consultations regarding the development of new policy.

CESR also performs tasks that extend beyond its consultation role, which include, *inter alia*, developing and reviewing common and uniform implementation methods at Level 3 to achieve harmonised regulatory standards in applying Community legislation; issuing voluntary guidelines, recommendations and standards for members to introduce into their regulatory practices; developing effective operational networks to promote consistent supervision across member states and cross-border coordination enforcing EU securities regulation; and assessing changes in financial markets along with global trends in regulation with consideration for the impact on the EU Single Market for financial services.[49]

Some weaknesses in CESR are that its members do not have equivalent degrees of authority in their respective jurisdictions to implement negotiated proposals. This can result in uneven implementation and enforcement of EU standards and rules, which may create competitive distortions in the market. In some jurisdictions, further complications could arise because there are several regulatory authorities responsible for securities and investment services regulation.(Goodhart, 1998).[50]

Moreover, the issues of transparency and accountability for both the ESC and CESR are important for efficient development of EU financial markets. Although they must submit annual reports to the Commission, the Council and the Parliament, the public does not have complete access to these reports and to the minutes of meetings. Potentially, the inter-institutional committee, envisaged in Article 15 of Regulation 1049/2001 of 30 May 2001 regarding public access to Parliament, Council and Commission documents,[51] could act to enhance transparency and accountability by proposing changes to the comitology procedures that create clearer lines of authority in administrative practices while providing improved public access to official deliberations.

The idea of establishing a EU securities regulator with authority to devise and adopt EU-wide standards and rules for securities regulation is premised on the notion that a single regulatory regime can reduce overall operating costs for firms and for the economy at large (Avgerinos 2003). The emerging EU regulatory framework is designed generally to fulfil the freedoms of the Common Market while also addressing the concern that globalisation and an overemphasis on regulatory costs can result in a 'race to the bottom' where competing jurisdictions cause a downward spiral of deregulation that will deprive investors and borrowers of adequate protections. On the other hand, the theory of international regulatory competition asserts that competing jurisdictions will produce the most efficient capital market regulation because they will try to attract financial businesses by establishing the most economically efficient laws and regulatory environment.[52] Empirical work has demonstrated that investors will impose a risk premium on investments issued or traded in an environment where those investors are not adequately protected from market manipulation.[53] In these circumstances, investors will charge higher premia for two types of regulations: (a) those which impose excessive burdens in the form of regulatory and opportunity costs, and (b) those which do not adequately protect investors from unscrupulous market behaviour. Investors will only consider the risk premium as sufficiently reduced when the regulatory environment provides an optimal balancing between investor protection and cost efficiency.[54] Issuers who fail to take account of investor concern will incur higher costs for raising debt or equity.

The above discussion shows how investors' concerns drive securities prices. Assuming that investors have more influence on the development of regulations or alternatively can choose which jurisdiction they would be willing to purchase securities, then these investor preferences would influence the development of rules that were closer to achieving efficient price formation in the marketplace. This would be a positive development in regulatory policy. In this way, market participants would contribute to the appropriate balance of regulations and this balance would be honed by competing regulations in other jurisdictions. Therefore, in the absence of additional empirical evidence, the concern with 'the race to the bottom' hypothesis is rather overstated.

In the European Community, a major development in the internal market has been the movement towards greater harmonisation of securities market laws and regulations amongst member states based on the principles of home country control and minimum harmonisation. Serious concern has been raised regarding the adoption of standards and rules in the Lamfalussy 4-level framework which might impede the efficient development of harmonised EU securities market rules because they are superimposed by EU authorities with little consideration for the organic development of regulation in response to market trends at the state level. No doubt there would be significant gains (discussed below) in convenience for companies and investors if rules were harmonised at the EU level, but there is no assurance that harmonised rules would always produce the most efficient result, especially if they are devised by regulators who are detached from recent market developments and the needs of participants. Moreover, the institutional structure of regulation may impact the design of efficient rules, and thereby impact market stability and confidence. This is why proposals for a EU securities regulator and for further consolidation of the regulatory framework through the Lamfalussy programme can impact efficiency in securities markets and undermine economic growth.

The theoretical basis for further centralisation of European securities regulation can be justified on the grounds of the normative and public interest theories of regulation. Although regulation can often be explained by the selfish economic and political objectives of interest groups, the policy rationale for regulation is usually couched in terms of the overall public interest. It is at that level where the regulatory policy debate must take place. Indeed, policymakers and administrators should seek to assess the role of regulation by weighing the advantages and disadvantages of specific programmes with respect to how regulatory standards and rules impact allocative efficiency in the marketplace and serve the overall public good.

V. Institutional Design

The rationale for inter-state coordination

The evolution of the European Community has involved a grand experiment in which some of the world's leading nation states have pooled increasing areas of policy authority by introducing collective institutions to regulate economic relations. International relations scholars have used several theoretical perspectives to explain these arrangements of collective governance. The most prominent of these is the 'intergovernmentalist' perspective, which conceptualises European integration as the practice of ordinary diplomacy under conditions creating opportunities to provide collective goods through highly institutionalised negotiations (Moravcsik 1993; Pierson 1998). This theory views the EC as an institutional form of collective action amongst nation states in which member state governments remain the only important actors at the EU level, and policymaking is conducted through negotiations amongst member state governments or through specific delegations of authority. Domestic actors ordinarily exert influence through national political structures of member states. The 'Chiefs of Government' ('COGs') are the key actors in the EC and seek to maximise their own advantage.

Inter-governmentalism draws upon rational choice theory that provides flexible conceptual tools to explain why national governments would favour particular outcomes (Green and Shapiro 1994; Pierson 1998). However, it lacks an over-arching theory to explain how transnational institutional structures create constraints on member state governments. It raises important questions, such as why member state governments desire certain outcomes; which governments exercise the most influence on the collective decision-making process; and which COG alliances can explain policy or institutional developments in the EC (Moravcsik 1991; Martin 1993; Pierson 1998). Moreover, it fails to account for how the EU has emerged as a more complicated and pluralistic structure that resembles more of a quasi-federal polity (Dehousse 1994; Majone 1992). This critical perspective is concerned less with advancing broad theories of economic and political integration than with detailed investigations of day-to-day EC policy development and the increasingly prominent role of EC institutions. Research in this area has focussed on specific issue areas in which inter-governmental policymaking has resulted in a dense and pluralistic political process, not completely controlled by national governments and not explicable by grand diplomatic bargains.

Another theoretical approach that exposes the limitations of intergovernmentalist accounts is neo-functionalism. Neo-functionalism originated as an optimistic analysis of the benefits of informal cooperation between states. The theory, deriving from David Mitrany's functionalist approach to world unification, has evolved over time to incorporate a more realist view of how power politics has shaped European integration (Haas, 1958).[55] Indeed, Haas examined how and why 'nation-states cease to be wholly sovereign, [and] how and why they voluntarily mingle, merge, and mix with their neighbours so as to lose the factual attributes of sovereignty while acquiring new techniques for resolving conflicts between themselves.'[56]

Despite the weaknesses and criticisms of neo-functionalism,[57] it provides some explanation of the emergence of institutional structures at the EC level to regulate the financial services sector. Minimum harmonisation is viewed by those who advocate European federalism as a transitory stage on the way towards European legal unity. On the other hand, minimum harmonisation has been viewed as a mechanism to preserve national autonomy and regulatory competition amongst states. Although EU federalism was initially designed to promote competition between national legal orders, the inter-governmentalist principles of minimum harmonisation and home country control have clearly reached their limit in fostering the development of more efficient regulation of the EU financial sector. Indeed, competition among national regulatory rules cannot be seen as an end in itself, but must be evaluated within a broader range of possibilities, such as the desirability of transferring power to EU institutions. To this end, centralising regulatory powers is important to avoid a reversion to national regulatory policies that might result in a fragmented and disjointed approach to devising regulation in the internal market (Bratton, 1996, p. 36). The introduction of a EU supervisory authority with responsibilities for the investment services industry would have as one of its major functions to ensure that rules are applied in the same way in all Member States.

Neo-functionalists were undoubtedly correct in assuming that the functional needs of an integrated European market would necessitate a considerable transfer of policy-making powers to the EU level (Majone,1996).[58] With a single currency and a single internal market, Thieffry has noted that the lack of a single regulator could undermine financial stability and result in less consumer/investor protection. Indeed, an important reason to delegate the powers to a politically-independent regulator is to enhance the credibility of the EU's long-term policy commitment to create a single financial market. Furthermore, certain weaknesses of the existing EU legal framework for regulating investment services can be summarised as follows: the cost of the securities industry operating in a fragmented EU market with blurred divisions between home and host supervisory powers; slow and fragmented legislative responses to market innovation; imperfect information exchange and deficient cooperation between member States supervisors; doubtful credibility and independence in existing national regulators; and lack of efficient crisis management situations. Given these weaknesses with the existing system, it is necessary to analyse the economic reasons for consolidating securities regulation within EC institutions.

Critics have argued that the Lamfalussy structure does not provide the institutional safeguards of political accountability to the EC Council and Parliament and will also create legislative delay and inflexibility in promulgating and implementing securities regulation in the Member States. Although some authors have argued that it is necessary to further streamline the institutional structure and the standard-setting process so that a Level 2 European Securities Committee can take the initiative in devising regulations and rules to implement broader legislative objectives set forth by the Commission and Parliament, such further institutional consolidation would require stronger economic links in cross-border trade in financial services to justify the substantial costs of establishing such a centralised regulatory framework. Once economic convergence and sufficient financial integration has occurred, a more centralised framework that goes beyond the Lamfalussy approach might be more effective in crafting uniform regulatory standards and rules that can be applied in an expedited manner throughout member state markets.

It should also be noted that the inter-governmental and neo-functional theories will continue to compete to explain the recently established Economic and Financial Committee (EFC). ECOFIN established the EFC to address EU economic and financial policies. It prepares the ECOFIN agenda and makes proposals for revising EU supervisory and regulatory frameworks for the internal market. In October 2002, the EFC issued a report that proposed that the Lamfalussy institutional arrangements for securities regulation be extended through inter-institutional agreements to other financial sectors, such as banking, insurance and financial conglomerates. These newly-established committees with four-level frameworks will exercise enhanced comitology powers. An inter-institutional monitoring group has been established to monitor communications between these committees.

Based on the EFC proposal, the Commission will be making a legislative proposal along these lines in 2003. The growing influence of the EFC has caused concerns regarding its accountability to the main EC governmental organs, the Commission, the Council, the Parliament and the Court of Justice; and as discussed below, it has become a crucial policy link in the emerging institutional framework of EU financial regulation.

The Institutional Viability of a Single Regulator

Ongoing efforts to centralise and consolidate EU securities regulation raises a number of critical economic and institutional issues regarding the economic costs and benefits of adopting a uniform regulatory regime that applies to all EU countries. The design of such a regime must take account of divergent economic structures in countries with vastly different administrative, regulatory and legal regimes. Some scholars criticise the centralisation of regulatory authority in the EU because it may lead to excessive concentration of federal powers and over-regulation that might stifle market innovation and diminish regulatory competition between member states. This may lead to a disregard of the special characteristics of national markets.[59] On the other hand, proposals for a single EU securities regulator is a response to fragmentation in financial policymaking and to insufficient cooperation and coordination between member states to ensure that EU regulatory policies are implemented and enforced. The effectiveness of a single regulatory regime is premised on the need for a one-size fits all legal framework to govern cross-border trade in securities in EU financial markets. Establishing a single regulator with preemptive authority over national regulation is designed to insulate EU policymaking from parochial local interests and the institutional interests of other EU bodies.

At a theoretical level, the costs and benefits of creating a single regulator can be assessed within the context of both transaction costs and sovereignty costs. One issue that arises concerns whether the reduced transaction costs and coordination benefits derived from a more centralised EU regulatory regime, along with reduced compliance costs for market participants, offset the sovereignty costs associated with the loss of regulatory authority for member states over local securities markets. The effectiveness of a more centralised approach will also depend on the institutional competence of EU authorities and their ability to coordinate the implementation and enforcement of regulatory policy with member state regulators. It is not necessary therefore to have a single regulator with exclusive responsibility for devising and enforcing EU standards. An EU securities regulatory regime can avoid incurring high sovereignty costs and still achieve the coordination benefits of reduced transaction costs by adopting an institutional framework that relies on effective coordination of standard-setting, implementation and enforcement.

Although there is attractiveness to the idea that more efficient securities regulation can be devised at the EU level, the uniform application of EU securities regulation throughout the member states would have a disproportionate impact on the economic structures of member states, some of which have significant differences in the structure of their financial services industry and in the way they regulate financial services. Indeed, differences in the institutional structure of financial regulation can lead to different regulatory objectives and rationales that might be changed alter significant if a single regulatory regime and authority were to take primary responsibility for EU securities regulation. Moreover, the centralisation of primary regulatory authority in a European Securities Regulator would only work if a prominent role were given to national regulators and supervisors to implement EU policy. There would still be a danger that uniform securites regulation, even if implemented by national authorities throughout the EU, would still not accomplish the economic objectives of lowering regulatory cost and enhancing economic growth and financial development. In practice, trends in market practice and financial products vary between jurisdictions, though there are increasing similarities, and that is why regulation must still rely on national supervisors to chart the regulatory field in order to most efficiently implement broader EU policy in financial services.

In addition, most economic analysis of the role of regulation in securities markets militates against the adoption of a single EU securities regulatory regime. Nevertheless, the driving forces behind any project to design the institutional structure of a regulator will be political. The Lamfalussy framework has arguably been successful in many of its tasks precisely because it has been driven by political forces and respects the sovereign authority of states. Successful development of the Lamfalussy programme would likely provide positive spillover effects for the parallel project of implementing the FSAP. On the other hand, a more centralised EU securities regulatory authority would reap coordination benefits of collective action as espoused by neo-functionalist theory. Moreover, the centralised exercise of regulatory power would lead to lower direct and indirect transaction costs. Further, there would be more flexibility of action than the existing Lamfalussy framework. Arguably, if the regulator is empowered to promulgate, repeal, amend, and interpret regulation, then the system should be able to provide the right amount of flexibility and efficient rulemaking.

Is the European Union an Optimal Economic Area for Securities Regulation?

There is little doubt that the Lamfalussy process has assisted the political goals of European Union and in particular the development of the internal market for capital and financial services. The future development of the Lamfalussy framework, however, depends on its ability to help countries reach their economic goals, that is, achieving efficient and integrated financial markets. But the centralisation and consolidation of EU standard setting and rulemaking can in principle lead to economic sacrifices as well as benefits. This paper contends that further extension of the Lamfalussy programme into a single EU regulator should only take place if EU financial markets have reached a sufficient level of integration. Establishing a single regulator before that time will entail enormous economic costs and misallocation of resources in EU financial markets. Advocates of a single regulator and a uniform securities regulatory regime have not given adequate consideration to the economic costs of linking all EU states (including accession states) to a unified EU securities regulatory regime. EU capital markets remain fragmented and segmented because of various economic, social and cultural factors. Moreover, member state legal systems have considerable differences in their definitions of property with respect to securities and investment services. The EU FSAP's efforts to harmonise and liberalise trade in EU financial services will not be sufficient to produce a fully integrated EU financial market. Further changes in market practices, investor preferences, and macroeconomic developments will have to take place before a single regulator will be able to effectively perform its functions.

This section argues that weighing the costs and benefits of establishing a single regulator must begin by assessing the extent of integration that exists in EU financial markets. The effectiveness of a single regulator, and indeed a uniform EU securities regime that applies in the same way throughout the Union, will depend on how well the securities markets of member-state economies are integrated with the securities markets of other member states economies. To conduct this analysis, the paper adopts the model of *Optimum Currency Areas*, derived from Robert Mundell's classic work, *The Theory of Optimum Currency Areas,*[60].which predicts that fixed exchange rates are most appropriate for economies that are closely integrated through international trade and factor movements. In securities regulation, this model can be applied to show whether a single trans-national regulatory regime is appropriate for economies with varying levels of integration in financial and investment services.

To apply this model, consider how an individual country, for example, Poland, would approach the decision of submitting the regulation of its securities markets to a single EU regulator or single regime. A simple diagram can demonstrate the choices faced by Poland (Appendix A). To demonstrate the benefits and costs for Poland of submitting its regulatory authority for securities markets to an EU regime, I derive two elements of a diagram, a schedule called *BB* which shows the potential economic and institutional gains of adopting the EU regime. The schedule depends on Poland's trade links in financial and investment services with other economies in the EU.

Poland's place on the schedule will derive from the benefits it gains from being subject to a uniform EU securities regime. For example, an important benefit would be the reduced cost in calculating the various requirements that different countries impose on foreign providers of financial services. By being subject to a uniform regime across EU border, Polish financial service traders will derive a more predictable regulatory regime from country to country. In practice, it may be difficult to calculate an exact cost savings for this type of benefit. The gain though will likely be higher if Poland has substantial trade links or high levels of financial integration with other EU countries.

The conclusion should be that a high degree of financial integration between a country and a single regulatory area increases the economic gain for the country seeking to join. The higher the level of cross-border trade in financial services and linkages in securities markets (ie., multiple listings in different jurisdictions) then the higher the efficiency gain the country derives from joining a single regulation area. In Chart A, the upward sloping curve *BB* shows the relation between a country's degree of financial integration with a single regulation area and the economic efficiency gain from being subject to a single regulation area. Chart A's horizontal axis measures the extent to which Poland is financially integrated with the EU economic area. The vertical axis measures the regulatory efficiency gain for Poland in transferring securities regulatory authority to EU institutions. *BB's* positive slope represents the view that the gains from a single regulatory regime increase for a country as its financial integration with the EU area increases.

A theory of optimum regulation areas can provide a framework for assessing whether a country or countries will benefit or incur costs by submitting regulatory authority over its securities markets to a transnational authority. Further empirical research is necessary to demonstrate a richer picture of the costs and benefits for a member state to adopt a uniform single regulatory regime in securities and investment services. The gains and losses experienced by a state is more likely to benefit from joining a single regulation area if the economic area in question (ie., the European Union) has high levels of financial integration with its own financial markets.

The efficiency gains from joining a single regulation area for securities markets equals the joining country's savings from avoiding the uncertainty, calculation, and transaction costs of having to comply with the various regulatory regimes of other countries with whom the joining country's service providers trade. A country, for example, Poland, is more likely to benefit from joining a single regulatory regime if its economy is closely integrated with the economies of the other countries subject to the single regulatory regime. For securities markets, the general degree of financial integration can be assessed by looking at the integration of financial services markets, that is, the extent of trade in investment and financial services between the joining country and the countries subject to the single regulatory regime. The other criteria is the degree of integration between factor markets, that is in the case of securities, the extent that capital moves between a joining country and the countries of a single regulation area.

Recent studies on financial integration in Europe rely on various data that measure price and returns on assets and quantity flows and stock[61] These studies generally show strong home bias for cross-border banking services and differential prices and returns on securities listed on different EU exchanges that are explained by aspects other than the rate of return and the risk of the investment. Also, substantially different interest rates exist for corporate loans and mortgage loans in different EU states.[62] This suggests low levels of integration in these financial services. Moreover, the international composition of assets in investment funds that are based in Europe also show strong bias, thus suggesting low levels of integration.

By contrast, the amount of cross-border trade in financial services between the States of the United States as a percentage of total US trade in financial services is between 50-55%.[63] The higher level of integration in US financial markets and in particular the high level of cross-border trade in financial services amongst the US states suggest that a more centralised federal regulatory regime is appropriate for US securities and investment services markets which is supplemented by state laws and regulation. In the case of the European Union, the substantially lower levels of integration justify the view that a more centralised and harmonised EU securities regulatory regime is inappropriate for EU financial policy.

Naturally, more study of the direct and indirect measures of financial integration should be undertaken before any conclusions are made regarding levels of integration in European financial markets. Moreover, any final policy conclusions regarding the institutional design and scope of securities regulation and the extent of harmonisation of EU securities legislation should await these studies.

Conclusion

Whilst supervisory tasks are often best performed as close as possible to supervised entities, increased cross-border and cross-sectoral activities in EU markets require institutional arrangements that facilitate information flows, setting high level principles at EU level, and coordinated decision-making regarding implementation and enforcement. To date, EU securities regulation has relied on strengthened cross-border and cross-sector cooperation amongst national authorities. This can lead to greater convergence in regulatory and supervisory practices and promote the single market by enhancing the ability of national supervisors to monitor cross-border financial institutions and transactions. These transnational regulatory developments have followed the gradual evolution of EU financial markets from highly regulated and segmented markets to increasingly liberalised regulatory frameworks that seek to build a truly internal EU market for financial services. An increasingly *liberalised* framework does not necessarily mean an increasingly *integrated* market. EU regulatory policy must address not only the regulatory and legal instruments for achieving an integrated EU financial market, but also the macroeconomic, social and cultural factors that keep financial markets segmented. The institutional design and scope of a EU securities regulator must take account of the nature of the financial markets it would regulate. Accordingly, an important factor determining the viability of an institutional structure of financial regulation is the nature and extent of integration in its financial markets. The effective discharge of its regulatory responsibilities requires that its roles and responsibilities be clearly allocated, that all regulatory and supervisory actors be accountable, and its institutional framework is suitable for the financial markets it regulates.

The main argument of this paper refines the latter point somewhat by arguing that the institutional design and scope of the financial regulator should depend, in part, on the degree of financial integration in the market it regulates. This paper argues that an important aspect in developing an efficient securities regulatory regime is to ensure that the market over which the regulator exercises jurisdiction has achieved a sufficient level of market integration. The degree of market integration is important for determining the possible reach of the externality that might arise because of market failure (ie., systemic risk). For instance, the scope of the negative externality arising from the under-pricing of risk might easily spread through a sufficiently integrated financial market and threaten financial stability. This should be a major factor influencing the institutional design and scope of authority of the regulator.

Higher economic integration often involves increased similarities in market practices between participants in different economies. Increased links and commonalities of practice lend themselves to a more uniform regulatory approach. In 2003, the degree of cross-border trade in financial services between EU member states is low relative to the degree of total financial services trade. This lack of sufficient economic links in the financial services sectors of the different member economies suggests that primary reliance for standard setting and implementation and enforcement should remain with national authorities. This does not negate the strong role that EU law and regulation can play. Rather, EU law and regulation must be incremental and expand its reach according to the increasing links that are growing between member state economies. When EU financial services are truly integrated on a cross-border basis, a stronger case could then be made for further consolidation and centralisation in the Lamfaulssy programme and perhaps even the establishment of a single regulator.

It is suggested that, because of its low level of financial integration, the European Union may not be an optimum economic area for securities regulation. The paper argues therefore that if levels of integration are in fact low the economic case supporting a centralised EU securities regulator is undermined, and that existing efforts under the Lamfalussy framework (albeit in need of reform in key areas) are more appropriate given the existing level of segmentation in EU financial markets.

This paper is the first step in further research that will be undertaken to assess the level of integration in EU financial markets and the link between financial market integration and the optimal institutional design of financial regulation.

[1]See Art. 105(2) of the Treaty establishing the European Community ('Treaty') and Article 3 of the Statute of the European System of Central Banks ('ESCB') and the European Central Bank ('ECB') recognises oversight as a *basic* task of the Eurosystem. Article 105 (2) of the Treaty and Article 3 of the Statute provide: 'The basic tasks to be carried out through the ESCB shall be […] to promote the smooth operation of payment systems'. Further, Article 22 of the Statute provides: 'The ECB and national central banks may provide facilities and the ECB may make regulations, to ensure the efficient and sound clearing and payment systems within the Community and with other countries'. The ECB's capacity to issue regulations in the area of payment systems has also raised the issue of the prudential role of the ECB *vis-a- vis* the national central banks.

[2]European Council Resolution of 23 March 2001 on more effective securities market regulation in the European Union, OJ L 138/1 of 11 May 2001, para. 3.

[3] See the Reports originating from discussions amongst the FESE and the Wise Men Group, chaired by Alexandre Lamfalussy: FESE, *Report and Recommendations on European Regulatory Structures (September 2000)*; Committee of Wise Men, *Initial Report on Regulation of European Securities Markets* (9 November 2000, hereinafter 'Initial Wise Men Report').

[4] The EU FSAP is premised on the notion that the elimination of national regulatory barriers to cross-border trade in financial services will be the essential factor in achieving an integrated market for financial services. This assumption that full liberalisation in trade for financial services will lead to full market integration will be questioned later in the paper.

[5] Hertig, G. and R. Lee (January 2003) 'Four Predictions about the Future of EU Securities Regulation', *Journal of International Banking Law and Regulation.* For a rebuttal, see M. McKee (July 2003) 'The Unpredictable Future of European Securities Regulation: A Response to Four Predictions about the Future of EU Securities Regulation by Gerard Hertig and Ruben Lee', Vol. 18, no. 7 pp. 277-283.

[6] Eatwell, J. & L, Taylor (2000) *Global Finance at Risk: The Case for International Regulation* Cambridge: Polity pp. 218-220.

[7] The phrase 'optimum economic area' is used deliberately as an analogy to Robert Mundel's classic work on 'optimum currency areas'. See Mundell, R., 'The Theory of Optimum Currency Areas', *American Economic Review* (Sept. 1961) pp. 717-725.

[8] The Cambridge Endowment for Research in Finance is undertaking research in this area and will be publishing some results in early 2004. Part of the research will assess key measures of financial market integration in Europe and whether this should influence the institutional design of EU regulation.

[9] National authorities would also play the primary role in implementation and enforcement.

[10] European Commission, Directorate General for Economic and Financial Affairs (2002) *Report by the Economic and Financial Affairs Committee on EU Financial Integration*, p. 15.

[11] The European Central Bank (2001) *The Euro and the Integration of Financial Services* pp. 24-27.

[12] These conclusions are discussed in greater detail in the following reports: 'Quantification of the macro-economic impact of integration of EU financial markets', London Economics (Nov. 2002); and 'Financial market integration, corporate financing, and economic growth', Centre for Economic Policy Reform (Nov. 2002).

[13] See Cabral, I., F. Dierick & J. Vesala (2002) 'Banking Integration in the Euro Area' *European Central Bank, Occasional Paper Series* No. 6 p. 11.

[14] These are known as EONIA banks (euro overnight index average).

[15] Ibid. At two basis points, or less, arbitrage opportunities no longer exist.

[16] Eaterbrook, F. & Fischel, (1991) *The Economic Structure of Corporate Law* p. 297.

[17] R. Coase, 'The Problem of Social Costs' (1960) 3 *Journal of Law and Economics* 1, pp. 42-43

.[18] Stigler, J. 'Public Regulation of Securities Markets' (1964) 37 *Journal of Business* 117. See also, G. Jarrell, 'The Economic Effect of Federal Regulation on the Market for new Securities Issues' (1981) 24 *Journal of law and Economics* 613.

[19] Lawrence, (1999). But he qualifies this assertion by stating that this fear has been mitigated by the increasingly important role played by institutional investors in checking the excesses and abuses of management and directors by utilising publicly available information that is incorporated into a company's stock price.

[20] Tomasic, R. & S. Bottomley, *Directing the Top* 500 (1993)

[21] OECD, *Economic Surveys: 2000-2001*

[22] Brealey, R. and S. Myers (1991) *Principles of Corporate Finance* (4th ed.) chap 2. See also, M. Coco, 'Towards Enterprisation: Shareholder Rights and Economic Reform in Russia' (1998) *Virginia Journal of International Law* 36

[23] Deakin, S. 'Law *Versus* Economics? Reflections on the Normative Foundation of Economic Activity' in M. Richardson & G. Hadfield (eds.), *The Second wave of Law and Economics* (1999) p. 30, 39. Indeed, basic applications of econometrics and data collection and analysis can provide useful insights into the regulatory debate.

[24] Hadfield, G. 'The Second Wave of Law and Economics: Learning to Surf' in M. Richardson and G. Hadfield (eds.) *The Second wave of Law and Economics* (1999) p. 50.

[25] See Goodhart, C.A.E. in Ferran, E. & Goodhart, C.A.E. *Regulating Financial Services and markets in the Twenty First Century* (2001).

[26] Art. 67-73, Treaty Establishing the European Economic Community (1957). The free movement of capital was established specifically in 1988 with Council Directive 88/361. Free movement of services was recognised in 1987 with the Second Banking Directive, which allowed the single passport for trade in banking services throughout the EC.

[27] Craig, P. & G de Burca (2003)(3rd ed.) *EU Law*, pp. 10-12, Oxford: OUP.

[28] Andenas, M. & Y. Avgerinos, *European Financial Regulation* (2002) London: Kluwer. See also, J.J. Norton, 'The European Community Banking Law Paradigm: A Paradox in Bank Regulation and Supervision – Reflections on the E.C. Second Banking Directive', in *International Banking Regulation and Supervision: Change and Transformation in the 1990s* (eds. J. Norton, C. Cheng and I. Fletcher) (Graham & Trotman, Martinus Nijhoff Pub, 1994.) 49-63.

[29] See Second Banking Coordination Directive, 89/646/EEC, [1989] OJ L386/1; Own Funds Directive 89/299/EEC; Solvency Ratio Directive 89/647/EEC; Consolidated Supervision Directive 92/30/EEC, [1992] OJ L110/52; Prudential Supervision Directive 95/26EC, [1995] L168/7; Investment Services Directive, 93/22/EEC; Capital Adequacy Directive 93/6/EEC, [1993] OJ L 141/1(introducing capital requirements for market risk and extends harmonised solvency supervision to investment firms).

[30] See First Banking Directive (1977), art 1. Second Banking Directive (1989) art 1(6).

[31] A host state can rely on the general good principle to restrict all single licence directives and impose liquidity controls. See K. Lannoo, (2002) 'Supervising the European Financial System', Centre for European Policy Studies.

[32] Ibid, p. 5.

[33] See Crispin Waymouth, Permanent official of the European Commission, 'Major Developments in EU Securities Market Legislation', Presentation before Polish securities regulators, Warsaw Poland (26 Nov. 2002).

[34] See http://europa.eu.int/comm The Commission adopted the Action Plan on 11 May 1999.

[35]Report of the Committee of Wise Men (Lamfalussy Committee) (Feb. 2001). The European Parliament endorsed the Lamfalusy approach in its Resolution of 5 February 2002.

[36] See IP/01/792 and Memo/01/213.

[37] Changes to qualified majority voting agreed at Nice (triple majority) have made decision-making in the Council more difficult and have shifted the balance in favour of large Member States for the first time in the history of the Union.

[38] European Commission, *Decision establishing the European Securities Committee* (COM(2001) 1493 final, 6 June 2001, hereinafter "ESC Decision").

[39] The HLSSC was an informal group set up by the Commission in 1985 and comprised high-level representatives of Member States' securities supervisory authorities, finance ministers and central banks. Chaired by the Commission, its primary role was to assist and advice the Commission on policy issues relating to securities markets and the development of the relevant EU legislation, rather than detailed technical questions. Here lies its greatest difference with its successor, the ESC.

[40] European Council, *Decision 1999/468/EC laying down the procedures for the exercise of implementing powers conferred on the Commission* (OJ L184/23, 17 July 1999, hereinafter "Comitology Decision").

[41] The ESC was initially proposed by the Final Wise Men Report, which was adopted by the Stockholm Council on 23 March 2001 and by the Parliament on 5 February 2002.

[42] Final Wise Men Report, 24.

[43] European Parliament, *Report on the implementation of financial services legislation* (A5-0011/2002 final, 23 January 2002, hereinafter "von Wogau Report") 8. The EP wishes, *inter alia*, one of its representatives to be able to attend meetings of the ESC and draws attention to its calls for the establishment of a genuine hierarchy of legal acts. It also takes the view that Article 202 of the EC Treaty has been rendered obsolete by the codecision procedure, as the EP and the Council should have an equal role in supervising the way in which the Commission exercises its executive role, and, thus, should be amended at the next IGC.

[44] See FESE, *Second Report and Recommendations on European Regulatory Structures* (January 2001) 10. FESE recommends that EU securities exchanges, under their capacity as regulators in various forms, be made members of the CESR, at least for issues that are wholly or partially within their remit. Moreover, it calls for more consideration on inviting the EP as observer in the ESC so as to optimise and strengthen the flow of information to the Parliament and increase its transparency and accountability.

[45]See Avgerinos, Y., 'Essential and Non-Essential Measures: Delegation of Powers in EU Securities Regulation' (2002) 2 ELJ 269**;** Lenaerts, K., 'Regulating the regulatory process: 'delegation of powers' in the European Community' (1993) 18 ELRev pp. 23-25.

[46] European Commission, *Decision establishing the Committee of European Securities Regulators* (COM(2001) 1501 final, 6 June 2001).

[47] See CESR, *Draft Statement of Consultation Practices* (CESR/01-007b, October 2001).

[48] In its first meeting on 11 September 2001, the CESR formally approved its Charter (*Charter of the Committee of European Securities Regulators*, CESR/01-002, hereinafter "CESR Charter"). Mr Arthur Docters van Leeuwen, Chairman of the Securities Board of the Netherlands, has been elected as Chair of the Committee for a mandate of two years.
[49] CESR Charter, Article 4.

[50] Goodhart, C. *et al*, *Financial Regulation: Why, How and Where Now?* (London: Routledge, 1998) 155.

[51] (OJ L 145/43, 31 May 2001).
[52] Romano, R. (1998) 'Empowering Investors: A Market Approach to Securities Regulation' *Yale Law Journal* 2359, 2363.
[53] Ibid.
[54] Ibid., pp. 2366-2367.
[55] Haas, E. (1958) 'The Uniting of Europe' in B. Nelson & A. Stubb (eds.), *The European Union, Readings on Theory and Practice of European integration* (London: Macmillan, 2nd ed. 1998).
[56]Haas, E. (1980) 'Why Collaborate? Issue-Linkage and International regimes' 32 *World Politics* 357, 358.
[57] Some scholars assert that neo-functionalism failed to provide an adequate explanation of the process of European integration. See R. Keohane and S. Hoffmann, 'Institutional Change in Europe in the 1980s,' in Keohane and Hoffmann (eds.) *The new European Community – Decisonmaking and Institutional Change* (Boulder, Westview, 1991) 1-40. See A. Moeavcsik, 'Preferences and Power in the European Community: A Liberal Intergovernmental Approach' (1993) 4 JCMS 473, 478-80..
[58] Majone, G *Regulating Europe* (London: Routledge, 1996) 66.
[59] See Lomax, R.Supervision in the Single Market' (1993) 3 Central Banking 36, 39
[60] Mundell, R. 'The Theory of Optimum Currency Areas', *American Economic Review* (Sept. 1961) pp. 717-725.

[61] See Adam, K., T. Jappelli, A. Menichini, M. Padula and M. Pagano (Jan 2002) 'Analyse, Compare, and Apply Alternative Indicators and Monitoring to Measure the Evolution of Capital Market Integration in the European Union' pp 6-10.
[62] Ibid.
[63] See Securities Exchange & Commission, (March 2001).

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