ARTICLES

THE EUROPEAN UNION'S INVESTMENT SERVICES DIRECTIVE

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1. INTRODUCTION

During the past fifteen years the European Union ("EU") has constructed, phase by phase, an increasingly detailed supranational securities regulatory structure for its twelve Member States. The EU has become the world's primary actor in accomplishing multinational regulatory harmony in the field of securities regulation. In its recent adoption of the Investment Services Directive, the EU has completed a critical chapter of its evolving regulatory code for the European capital markets. The Investment Services Directive has been described as granting a passport for EU securities firms to conduct cross-border operations anywhere in the EU based on a license issued by their respective home states.

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3 Prior to its adoption, the proposed Investment Services Directive was described in numerous articles. See, e.g., Charles Abrams, The Investment Services Directive, in 14 COMP. L.Y.B. INT'L BUS. 311 (special vol. 1992); Caroline Bradley, Competitive Deregulation of Financial Services Activity in Europe after 1992, 11 OXFORD J. LEG. STUD. 545 (1991); Patrick M. Creaven, Inside Outside Leave Me Alone: Domestic and EC-Motivated Reform in the
 Appropriately, this description notes one of the Directive's monumental achievements. The Directive's scope, however, encompasses vast areas of complex regulatory concerns that go far beyond the necessary expedient of a mutually-recognized licensing scheme for the common market. The Directive's multistate licensing scheme, while critical to the establishment of an internal market for financial services, was from the beginning based on an uncontested conceptual verity. After all, the Treaty of Rome,\(^4\) as amended by the Single European Act,\(^6\) mandates free movement of capital and services and the right of establishment throughout the EU.\(^6\) No similar consensus existed on a number of related controversies that emerged, frustrating negotiations over the terms of the

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\(^{4}\) **TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [EEC TREATY]** [hereinafter TREATY OF ROME].


\(^{6}\) **TREATY OF ROME**, *supra* note 4, arts. 52-58. The Treaty provides a right of primary establishment for legal or natural persons who are nationals of any Member State, as well as a right of secondary establishment for branches and subsidiaries. *See id.*

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Directive, dividing the Member States into virulent northern and southern camps, and delaying the Directive's adoption for five years.

Arising from the inevitable clashes between twelve differing regulatory cultures, these issues included: (1) accommodation of the interests of Member States having universal banking traditions with those Member States in which commercial and investment banking are separated by rule or practice; (2) reduction or elimination of the internal market risk of "regulatory arbitrage" the accompanying disparate economic effects of investment firms pursuing licenses in the less-regulated Member States; and (3) whether prudential rules and conduct-of-business rules should be applied to investment firms by the home state where authorization was required or, instead, by the host state where business operations were conducted. In addition, fundamental questions were raised regarding market structure and transactional disclosure, including: (1) whether securities markets should be divided into wholesale and retail segments; (2) whether the markets should be quote-driven and screen-based or order-driven and floor-based; and (3) whether securities markets should be fully transparent, with real-time reporting of price and volume information, or relatively opaque, with minimal or delayed reports to protect investment firms' market positions. Defying virtually all predictions, the Member States resolved—or at least sidestepped—these issues sufficiently to produce a comprehensive regulatory regime for EU investment firms.

The EU Council of Ministers reached a consensus on the Directive prior to the self-imposed deadline of December 31, 1992. After completing the required cooperation

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7 The concept of regulatory arbitrage reflects the debatable notion that investment firms will migrate from one jurisdiction to another to avoid markets subject to relatively more stringent rules. See Global Harmonization, supra note 1, at 189-90.

8 The Council of Ministers, established by the Treaty of Rome, makes the final decision on legislative measures proposed by the Commission. TREATY OF ROME, supra note 4, arts. 145-54; see infra note 20. The Council is empowered under the Single European Act to adopt most measures by "qualified majority" voting, based on a weighted voting formula which, in the last decade, has greatly increased the EU's pace of unification. See Single European Act, supra note 5, art. 5.

9 The EU's 1992 program, including the deadline for its completion, was
procedure, the Council finally adopted the Investment Services Directive on May 10, 1993. Its major provisions are intended to provide: (1) common minimum authorization or licensing requirements among the Member States; (2) mutual recognition of the license granted in the home state by all other Member States or "host states"; (3) prudential rules establishing common minimum financial soundness standards among the Member States; (4) certain guiding principles for adoption of conduct-of-business rules by the host states; (5) direct access to each Member State's domestic stock exchange for both outside investment firms and banks; (6) requirements for concentration of securities trading in regulated markets which preserve investor choice to trade in less-regulated off-exchange markets; (7) minimum transparency rules for regulated markets; and (8) reciprocity for non-EU firms to participate in the newly-integrated marketplace.


10 The Single European Act, which introduced the EU's cooperation procedure, provides the framework for the enactment of EU laws by the Commission. Under this framework the Commission initiates all proposals while the European Parliament acts solely in a consultative role. The Council of Ministers has a dual function, as it first adopts a common position with regards to the proposal and later makes the final decision regarding adoption. Single European Act, supra note 5, art. 7.

11 Investment Services Directive, supra note 2, art. 32.

12 Id. art. 3.
13 Id. art. 14(1), (2).
14 Id. art. 10.
15 Id. art. 11.
16 Id. art. 15.
17 Id. art. 14(3), (4).
18 Id. art. 21.
19 Id. art. 7.

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This Article will first describe briefly the EU's previous achievements in the field of securities regulation, including the policies underlying the proposal and adoption of the Investment Services Directive. Then, it will survey the scope and the major provisions of the Directive and discuss the more controversial issues that divided the Member States into opposing camps. In its analysis of the Directive's substantive terms, this Article will note several of the Directive's deficiencies, including the failure to establish minimum commonality in the areas of administrative and judicial remedies for investors, conduct-of-business rules and transactional disclosure. The Article will conclude by noting that the Directive, despite its limited success in achieving an integrated European market system, represents a remarkable advance in the development of the EU's multinational securities code.

2. THE LEGISLATIVE CONTEXT

The Investment Services Directive is the latest step the EU has taken toward the creation of a single market for financial services from a fractious complex of twelve disparate regulatory systems. From the beginning, the EU Commission faced a formidable task. Professor L.C.B. Gower, whose work led to the United Kingdom's Financial Services Act of 1986, observed recently that securities regulation has been virtually nonexistent in continental Europe. To illustrate, in the 1980's, seven of the twelve EU countries did not require prospectus disclosure to investors in public offerings, and none had a securities regulatory agency to enforce the laws that did exist. As of five years

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20 The Commission, comprising 17 members appointed by mutual agreement among the Member States, is charged with the implementation of the Treaty of Rome and is granted the sole power of initiative in proposing and implementing legislation. TREATY OF ROME, supra note 4, arts. 155-63.


22 See Global Harmonization, supra note 1, at 194-95.

23 Id. at 195.
ago, nine of the twelve Member States failed to impose any criminal penalties for insider trading of securities.\textsuperscript{24} This absence of regulation in Europe's domestic securities markets had as its corollary a lack of free access to those markets. Various regulatory controls relating to currency exchange, capital market access and other protectionist measures formed high non-tariff barriers to domestic market entry by outside investors and investment firms.\textsuperscript{25} The combination of de minimis regulation and the lack of access to the EU's domestic securities markets constituted a marginally rational substitute for more comprehensive regulation. Minimum regulation, whether by government or industry, is certainly more plausible in a closed market than in an open market accessible to the rest of Europe and the world. For socio-cultural reasons alone, it has to be assumed that a nation's control of its own resident players is a far more facile task than controlling an infinite variety of alien players. Thus, common market accessibility created new regulatory demands. This presented a dual risk of: (1) protectionist regulatory discrimination against outsiders; and (2) enormous compliance costs for investment firms in dealing with twelve enhanced and contrasting regulatory schemes. The EU's laudable achievement has been to force capital market access, while at the same time creating a significant degree of regulatory harmony by adopting common minimum standards for all Member States. Additionally, implementation of the standards has been achieved through the requirement of

\textsuperscript{24} See Manning G. Warren, The Regulation of Insider Trading in the European Community, 48 WASH. & LEE L. REV. 1037, 1040-41 (1991) [hereinafter Insider Trading]. In the absence of criminal prohibitions, insider trading in Europe has been regarded as a major tenet of trading strategy in the EU's securities markets, and may explain why comparatively few Europeans are direct owners of equities. See Glenn Whitney, Europe Moves to Curb Insider Trading, WALL ST. J., Nov. 4, 1993, at A11. One writer recently observed that "ridding Europe of insider dealing will require a radical shift in the mindset of market participants" to develop a new morality. Id. Even with new laws on the books of the Member States, enforcement is likely to prove very difficult without "a unified EC financial markets regulatory body to coordinate cross-border investigations." Id.

mutual recognition of each Member State’s regime by all other Member States.\textsuperscript{26}

While various Member States exploded their respective “big bangs” and “little bangs” of access deregulation,\textsuperscript{27} the EU Commission proposed a number of “directives,” or mandatory “model acts” which have been approved by the Council of Ministers. These directives, the most common form of EU legislation,\textsuperscript{28} required conforming legislation, or transposition, by each Member State to implement the common standards established by them within a prescribed time period. Some of the more significant EU efforts to harmonize the rules for the securities industry have included the following directives:

1) Admission Directive (1979).\textsuperscript{29} This directive established common listing requirements for EU companies which decide to list on any domestic stock exchange in the EU. In addition to quantitative criteria, it also imposes qualitative requirements, including a duty that listed

\textsuperscript{26} The term “mutual recognition” refers to the achievement of a reciprocal agreement in which each Member State agrees to recognize and accept for its own regulatory purposes the regulatory requirements applied by the other states. The underlying political justification for this hybrid reciprocity is that the regulatory regimes of each Member State must satisfy EU-mandated minimum regulatory standards. In turn these standards are intended to establish substantial equivalence among the various Member States. See Global Harmonization, supra note 1, at 191-93; see generally Warner, supra note 3.

\textsuperscript{27} The term “access deregulation,” as coined by the author, refers to the reduction or elimination of various regulatory barriers to domestic market entry in order to facilitate foreign participation. See Global Harmonization, supra note 1, at 187-88.

\textsuperscript{28} The EU’s directives have been described as “the classic method of integrating [European] Community policy into the national law of the member states.” Patrick E. Thieffry, et al., The Single European Market: A Practitioner’s Guide to 1992, 12 B.C. INT’L & COMP. L. REV. 357, 360 (1989). The Treaty of Rome provides that “[d]irectives shall bind any Member State to which they are addressed, as to the result to be achieved while leaving to domestic agencies a competence as to form and means.” TREATY OF ROME, supra note 4, art. 189.

companies publish, on a timely basis, all material developments which might affect share prices.30

(2) **Information Directive (1980).**31 This directive requires all companies which decide to list on any domestic stock exchange in the EU to file with the exchange a disclosure document called "listing particulars." It was subsequently amended by two Mutual Recognition Directives52 providing that once they are approved in any Member State, the listing particulars of a given company must be recognized by all other Member States without any significant additional approval requirements.33

(3) **Interim Reports Directive (1982).**34 This directive requires all companies listed on a domestic stock exchange in the EU to publish, on a comparative basis, biannual reports on their activities, profits and losses, along with a "soft information" statement of prospects for the following six months.

(4) **Mutual Funds Directive (1985).**35 This directive, amended in 1988,36 established common standards for open-ended

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30 Admission Directive, supra note 29, art. 17(1) and schedule C.
33 Id. See Global Harmonization, supra note 1, at 213-14.

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collective investments in transferable securities, including harmonized rules pertaining to authorization, supervision, structure, activities and disclosure obligations of mutual funds. Once the mutual fund is authorized in the Member State where its management company has its registered office, the mutual fund may be marketed in any of the Member States.

(5) Major Shareholdings Directive (1988). This directive, sometimes referred to as the “anti-raiders directive,” requires shareholders to disclose the extent of voting rights in EU companies whenever purchases or sales of equity securities meet specified percentage thresholds.

(6) Prospectus Directive (1989). This directive established a prospectus requirement and general disclosure standards in connection with public offerings of securities in the EU. If the prospectus is prepared in accordance with the Information Directive and is approved by one Member State’s competent authority, the prospectus must be given full recognition by all other Member States where the securities are offered to the public.

(7) Insider Trading Directive (1989). This directive established a Union-wide prohibition against the trading of securities or tipping others on the basis of non-public material information. The directive defines the term “insider dealing” and extends the trading and tipping prohibitions to “primary insiders,” a term which includes all insiders and outsiders who come into possession of non-public material information by virtue of their position. The trading, but not the tipping, prohibition is also extended to “secondary insiders,” a term which includes all other outsiders who come into possession of the information.

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(8) **Second Banking Directive** (1989).40 This directive established common standards for bank authorization by any bank's home state and mutual recognition of that authorization by all Member States where a bank decides to engage in specified activities. These specified activities include not only the traditional banking services of accepting deposits and lending but also most of the services traditionally provided by investment firms. These services include trading and underwriting securities, portfolio management, corporate finance, and merger and acquisition services.41 Thus, the banks in Member States permitting universal banking are able to provide both commercial banking and investment services with a single license throughout the EU.

(9) **Capital Adequacy Directive** (1993).42 This directive established the minimum capital requirements applicable both to investment firms and to the portfolios or trading books of banks. The directive sets levels for initial capital investment, defines admissible regulatory capital, details minimum capital requirements for specific financial risks and contains measures addressing large exposure to single counterparty risk.

With these securities law directives in place, the EU has established a far-reaching regulatory framework for implementation by the Member States, and, at least for duly

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authorized banks, an accessible, integrated marketplace for the provision of investment services. It was understood, of course, that the Second Banking Directive, without similar legislation for non-bank investment firms, would give the EU's banking industry a considerable competitive advantage.\textsuperscript{43} In order to create parity for investment firms, the EU Commission modeled the Investment Services Directive after the Second Banking Directive and intended it to take effect at the same time: January 1, 1993.\textsuperscript{44} The first day following the deadline for implementation of the Investment Services Directive is January 1, 1996,\textsuperscript{45} with the resulting delay in harmonization giving banks a three-year head start. According to one writer, "the field will indeed be single, but still sloping from one end to the other."\textsuperscript{46}

The EU's legislative program to unify the financial markets of the twelve Member States has been premised largely, if not completely, on economic rather than political considerations. A report prepared for the Commission conservatively estimated that the economic gains from a single market in financial services would exceed $26 billion.\textsuperscript{47} Nowhere is the need for integration more evident than in the EU's securities markets. The forty stock exchanges in the twelve Member States, if combined into an integrated European market system, would have a market capitalization rivaling that of the New York Stock Exchange.\textsuperscript{48} As one European financier observed several years ago, "the costs of a fragmented European equities market are bankrupting the industry."\textsuperscript{49}

\textsuperscript{43} Investment Services Directive, supra note 2, pmbl. See also Redhead, supra note 3, at 199; Wolff, supra note 3, at 126.

\textsuperscript{44} See DEPARTMENT OF TRADE AND INDUSTRY, EC INVESTMENT SERVICES DIRECTIVE: A CONSULTATIVE DOCUMENT 2 (1990) [hereinafter DTI CONSULTATIVE DOCUMENT].

\textsuperscript{45} Investment Services Directive, supra note 2, art. 15.

\textsuperscript{46} Financial Services in Europe: Single, But Not Level, ECONOMIST, Feb. 23, 1991, at 83.

\textsuperscript{47} CECCHINI REPORT, supra note 9, at 37.


\textsuperscript{49} Id. at 27. The EU's securities markets suffer from geographic fragmentation that has resulted from the political boundaries of the 12 Member States and the efforts of each to protect its own market from competition. Moreover, similar to the SEAQ International, which ultimately may develop into "a full scale European Interprofessional Market ("EIM"),
Clearly, a unified financial market would generate economies of scale necessary for greater efficiency and liquidity.

Until recently, only London’s International Stock Exchange and its SEAQ International could rightfully assert claims to an international marketplace. After abandoning the floor-based London Stock Exchange for the first screen-based, quote-driven market in Europe, the London markets currently dominate international securities trading in European securities.50 Most of London’s domination has been in the wholesale market, with SEAQ International being utilized primarily by large professional and institutional investors. According to estimates, SEAQ International, with its fifty-five market makers quoting some 750 international stocks, handles 95% of Europe’s cross-border equity trading51 and roughly two-thirds of the world’s cross-exchange trading (i.e., the buying and selling of foreign equities in one’s home market).52 Moreover, it attracts over 50% of all trades in French and Italian equities and a third of the trades in German blue chip companies.53 Thus, the United Kingdom’s SEAQ International has become a major rival to the domestic exchanges of the other Member States.

Understandably, the Member States on the continent have targeted the London markets in order to bring the trading in their equity securities back home. More importantly, they recognize that their secondary markets must be equally accessible and more fully integrated to facilitate capital formation by issuers, to attract capital investment and, consequently, to increase overall market depth and liquidity. The United Kingdom, on the other hand, with its considerably stronger reputation, experience and dominance in international securities markets, is likely to maintain and even improve its position due to its greater access to issuers

the EU’s securities markets are also fragmented into wholesale and retail markets.” Unsettled Controversies, ECONOMIST, Sept. 5, 1992, at 84. By segregating wholesale and retail customers, the EIM might seriously reduce liquidity and worsen prices for retail investors. Id.


53 Id.

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and investors in the other Member States. The difficult and protracted debate over the Investment Services Directive prior to its adoption demonstrates that no true consensus has developed regarding the necessity of a single central market, whether in the form of an EU-wide screen-based secondary market for all major European securities or an interlinked network of national stock exchanges. Despite the progress of the EU thus far, financial nationalism remains a major force. It is inevitable, however, that in the long run "the need for liquidity, high-quality prices and a common body of accepted dealing procedures will help some sort of central market to emerge." By providing critical cross-border access in the EU and common minimum standards for investment firms, the Investment Services Directive represents a major advance towards an integrated European securities market.

3. THE MAJOR TERMS OF THE DIRECTIVE

As originally proposed by the Commission to the Council, the Investment Services Directive basically tracked the Second Banking Directive in order to provide investment firms similar free access to the securities markets of the Member States. Although it was intended to achieve the radical goal of breaking down the various Member States' protectionist, non-tariff barriers to domestic market entry, the Directive did not become radically controversial until the French proposed amendments introducing market transparency standards, concentration requirements and direct access for universal banks to stock exchange membership. It was primarily these issues which stalled adoption of the Directive, thus providing banks with an advantageous three-year head start in entering the domestic securities markets of the Member States. These issues, more than any others, divided the Member States into opposing camps and began the deliberative war between the so-called Club Med, comprising France, Italy, Spain, Portugal, Greece and Belgium, and the North Sea Alliance, comprising the United Kingdom, Germany, Ireland, Luxembourg, the Netherlands and Denmark. These two

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64 Capital Markets Survey, supra note 48, at 28.
groupings of Member States finally reached compromises in the summer of 1992, thereby removing the major obstacles to the Directive's adoption. These compromises will be discussed further in the following analysis of the major provisions of the Directive. In order to gauge the impact of those provisions, however, one must first examine the scope of the Directive.

3.1. Scope Of The Directive

The general approach of the Directive is set forth in one of its initial recitals:

[T]he approach adopted is to effect only the essential harmonization necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision systems, making possible the grant of a single authorization valid throughout the Community and the application of the principle of home Member State supervision; [and] by virtue of mutual recognition, investment firms authorized in their home Member States may carry on any or all of the services covered by this Directive for which they have received authorization throughout the Community by establishing branches or under the freedom to provide services.

The breadth of this approach and the single license that it envisages is dependent on how broadly the term "investment firm" is defined and the types of services and investment instruments covered by the Directive.

The term "investment firm" is defined to include "any legal person the regular occupation or business of which is the provision of investment services for third parties on a professional basis." The "investment services" covered

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57 Investment Services Directive, supra note 2, pmbl.
58 The Directive also permits Member States to extend the passport to natural persons, subject to specified conditions. See id. art. 1(2).
59 Id.
60 Id. art. 1 (1).
by the single license, as set forth in an annex to the Directive,\(^61\) include: (1) the reception and transmission of orders on behalf of investors\(^62\) as well as the execution of those orders; (2) dealing for one's own account; (3) managing portfolios for investors on a discretionary client-by-client basis; and (4) underwriting or placing issues.\(^63\) These services must relate to certain investment instruments, also set forth in the annex to the Directive.\(^64\) These instruments include: (1) transferable securities\(^65\) and mutual fund units; (2) money-market instruments;\(^66\) (3) financial futures contracts, including equivalent cash-settled instruments;\(^67\) (4) forward interest-rate agreements; (5) interest-rate, currency and equity swaps; and (6) options to acquire or dispose of any of the

\(^{61}\) See id. annex, § A.

\(^{62}\) See id. pmbl. Concern was expressed regarding the imprecision of this language; a preference was expressed instead for inclusion of the term "brokerage services." See THE LAW SOCIETY, EC INVESTMENT SERVICES DIRECTIVE COMMENTS ON THE DTI CONSULTATIVE DOCUMENT, (Sept. 1990) at 3-4 [hereinafter LAW SOCIETY COMMENTS]. The term "investment services" does include "bringing together two or more investors thereby bringing about a transaction between those investors." Investment Services Directive, supra note 2, pmbl. But note, the Directive specifically excludes from its scope firms which receive and transmit orders to specified types of counterparties and which do not hold client funds or securities. See id. pmbl., art. 2(2)(g).

\(^{63}\) It was suggested that sub-underwriting be specifically excluded. See DTI CONSULTATIVE DOCUMENT, supra note 44, at 6.

\(^{64}\) See Investment Services Directive, supra note 2, annex, § B.

\(^{65}\) See id. art. 1(4). The Directive defines "transferable securities" as: shares in companies and other securities equivalent to shares in companies, bonds and other forms of securitized debt which [shares and bonds] are negotiable on the capital market, and any other securities normally dealt in giving the right to acquire any such transferable securities by subscription or exchange or giving rise to a cash settlement, excluding instruments of payment.

\(^{66}\) See id. art. 1(5). The directive defines "money-market instruments" as "those classes of instruments which are normally dealt in on the money market." Id.

\(^{67}\) It was suggested that the term be restricted to those that are actually investment-related, including interest rate, exchange rate and other exchange-traded instruments. See LAW SOCIETY COMMENTS, supra note 62, at 5. "Instrument equivalent to a financial-futures contract" is defined as a contract settled by a cash payment calculated by reference to interest or exchange rate fluctuations. Investment Services Directive, supra note 2, pmbl.
covered instruments. In addition, the annex sets forth "non-core services" which are covered by the single license but are required to be ancillary to the primary investment services for which home state authorization must be sought under the Directive. These non-core services include, among others, safekeeping and safe custody services, margin lending services, corporate finance advisory services, underwriting services, investment advisory services and foreign exchange services.

After defining the term "investment firm" by reference to the services and investments listed in its annex, the Directive then sets forth numerous exclusions. As a result, the Directive does not apply to: (1) insurance companies; (2) firms which provide investment services solely to affiliated entities or to employee-participation schemes (or both); (3) incidental investment services provided by regulated professionals, presumably lawyers and accountants; (4) central banks; (5) firms which do not hold client funds or securities and which do not provide investment services except to receive and transmit transferable securities or mutual fund units only to authorized investment firms, credit institutions, mutual funds and investment companies; (6) mutual funds and their managers and depositaries; (7) commodities traders; and

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68 Investment Services Directive, supra note 2, annex, § C.
69 The Directive provides that an investment firm which intends to provide any of these ancillary services cross-border under the single passport must obtain home state authorization of at least one primary investment service as well as the ancillary services to be provided. See id. art. 3(1).
70 See id. annex, § C.
71 See id. art. 2(2).
72 See id. art. 2(2)(a).
73 See id. art. 2(2)(b).
74 See id. art. 2(2)(d).
75 See id. art. 2(2)(e).
76 See id. art. 2(2)(c). The exclusion for members of the professions was supported by the rationale that lawyers and accountants normally provide investment services incidental or subordinate to their primary professional services. See DTI CONSULTATIVE DOCUMENT, supra note 44, at 11.
77 See Investment Services Directive, supra note 2, art. 2(2)(f).
78 See id. art. 2(2)(g). The exclusion further requires that these firms' activities be governed at a national level by rules of ethics. See id.
79 See id. art. 2(2)(h).
(8) certain financial-futures and options market dealers.\textsuperscript{81} Despite these exclusions, the Directive's scope remains remarkably broad in its coverage and hence provides a single passport for a wide array of investment services. Moreover, it should be noted that the failure to cover, or the explicit exclusion of, investment activities by the Directive does not bar those activities from being provided by a Member State firm.

The inclusion of investment advisory services among "non-core services" is of particular interest because it results in the denial of an EU-wide license to investment advisers who only provide investment advice and none of the listed core investment services. The United Kingdom's Department of Trade and Industry ("DTI") advanced the position, without success, that investment advice should be an authorizeable service in its own right in order to make the single license available to pure investment advisers.\textsuperscript{82} The Commission excluded investment advisers from the scope of the Directive based on its view that investment advice is not generally practiced in Europe as a separate profession but usually is incidental to brokerage and portfolio management services.\textsuperscript{83} Thus, under the Directive, investment advisers will not be able to avail themselves of the passport and will not be subject to the EU's common minimum authorization and prudential rules. In cases where it is already possible for a firm to provide advisory services in other Member States, the host states may not impose new restrictions under the Treaty of
Rome, absent proof that those restrictions were objectively justifiable.\textsuperscript{84}

The Investment Services Directive applies not only to investment firms but also to banks and other credit institutions that provide investment services. Banks already covered under the Second Banking Directive,\textsuperscript{85} however, do not have to reapply for authorization under the Investment Services Directive.\textsuperscript{86} These banks already have a Union-wide license. The major provisions of the Investment Services Directive applicable to banks are those relating to home state prudential rules, host state conduct-of-business rules, investor compensation plans, the concentration requirement, access to membership in stock exchanges, regulatory enforcement, and reporting requirements.\textsuperscript{87}


The following discussion addresses the more significant and controversial operative provisions of the Directive. One should not assume that various other provisions treated only in passing or excluded from the analysis entirely are unimportant or ultimately may not be greater sources of controversy. The major provisions discussed below proved to be the most critical in the development and eventual adoption of the Directive. These major provisions include those relating to home-state authorization, mutual recognition, prudential rules, conduct-of-business rules, access to stock exchange membership, concentration, market transparency, and reciprocity for non-EU states.

3.3. Home-State Authorization

The Directive embraces the principle of home country control and prescribes the Union-wide minimum criteria that must be satisfied before a firm may be authorized by the home

\textsuperscript{84} See DTI CONSULTATIVE DOCUMENT, supra note 44, at 3.
\textsuperscript{85} See supra note 40.
\textsuperscript{86} See Investment Services Directive, supra note 2, art. 2(1). It should be noted that Article 3 of the Directive, requiring home state authorization of investment firms, is not among the specified provisions applicable to banks.
\textsuperscript{87} Id.
Member State. The five minimum conditions for home-state authorization of investment firms include the following:

(1) The firm must have its head office in the Member State where it seeks authorization,88 thus assuring that the authorizing Member State is the home state and preventing circumvention of home-state regulatory regimes;

(2) the firm must demonstrate sufficient initial capital, as specified in the Capital Adequacy Directive,89 with respect to the investment services to be provided;90

(3) the firm’s management, directed by at least two persons,91 must be shown to be of “sufficiently good repute” and “sufficiently experienced;”92

(4) the firm must submit a business plan or “programme of operations” setting forth the types of business envisaged and the firm’s organizational structure;93 and

(5) the firm must disclose “the identities of shareholders or members, direct or indirect, whether natural or legal persons, that have ‘qualifying holdings’ and the amounts of those holdings,”94 and it must demonstrate that those persons satisfy the home state’s “suitability”

88 Id. art. 3(2). This anti-circumvention rule is intended to reduce possibilities for regulatory arbitrage within the EU. The Directive requires Member States to deny authorization where it is clear that “an investment firm has opted for the legal system of one member state for the purpose of evading the stricter standards in force in another member state.” Id. pmbl.


90 Investment Services Directive, supra note 2, art. 3(3).

91 Id. The Directive does grant Member States authority to except from this two-man management, or “four eyes” rule, those firms, including partnerships, whose single manager satisfies similar reputation and experience standards. Id.

92 Id.

93 Id. art. 3(4).

94 Id. art. 4. The Directive extends these disclosure requirements to proposed acquisitions of investment firms, as well as increases and decreases of qualifying holdings that would meet or cross thresholds of 20%, 33% or 50% of the voting rights or capital of an investment firm. Id. arts.

91(1), 9(3).
Similar to criteria for "controlling person" and "associate" status under the federal securities law of the United States, the term "qualifying holding" is defined to mean "any direct or indirect holding... which represents 10% or more of the capital or voting rights or which makes it possible to exercise a significant influence over the management of the investment firm...."  

The most problematic aspect of these authorization conditions is the indeterminate nature of the terms "good repute" and "suitability." Neither term is defined in the Directive. Obviously, both go beyond financial capability since minimal capitalization is a separate requirement incorporating the newly-adopted Capital Adequacy Directive. Both terms are likely to take on different meanings in the different regulatory cultures of the Member States. Despite those differences, under the new single license, the good repute and suitability determinations made pursuant to home-state standards are required to be respected by host-state authorities even if those standards are deplorably low in comparison to those of a particular host state.

For an authorized investment firm to maintain its authorization, it must meet certain continuing obligations established by the home state. These continuing obligations, which must be satisfied at all times to avoid withdrawal of the firm's authorization by the home state, include the following:

(1) The firm must make actual use of the authorization within twelve months;  

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95 Id. art. 4. The "suitability" standard is to be determined by the competent authorities of each authorizing home state based upon "the need to ensure the sound and prudent management of an investment firm ...." Id.


97 Investment Services Directive, supra note 2, art. 1(10).

98 See Capital Adequacy Directive, supra note 42.

99 See Investment Services Directive, supra note 2, art. 3(7).

100 See id. art. 3(7)(a).
(2) the firm must not have obtained authorization by misrepresentation or "other irregular means;" 101
(3) the firm must continue to fulfill the initial authorization conditions; 102
(4) the firm must continue to comply with the provisions of the Capital Adequacy Directive; 103
(5) the firm must not have "seriously and systematically" violated the applicable prudential and conduct-of-business rules; 104 and
(6) the firm must comply with all other home state laws that provide for withdrawal of a firm's authorization. 105

The home state is charged by the Directive with the responsibility of requiring compliance with these authorization conditions, including the capital requirements imposed by the Capital Adequacy Directive, and of supervising compliance with the applicable prudential rules. 106 Only the home state's competent authorities have the power to withdraw an investment firm's authorization.

3.4. Mutual Recognition And The Passport

The Directive provides a Union-wide passport or single license by requiring mutual recognition by host states of all home state authorizations. 107 This mandatory deference to the home state constitutes the heart of the Directive. Thus, once an investment firm is authorized by its home state to provide specified investment services, the firm may establish a branch in any other Member State or otherwise provide services in any other Member State. 108 The other Member States, as host states, are expressly prohibited from making the establishment of a branch office or the provision of services

101 See id. art. 3(7)(b).
102 See id. art. 3(7)(c).
103 See id. art. 3(7)(d).
104 Id. art. 3(7)(e).
105 See id. art. 3(7)(f).
106 See id. art. 8(2), (3).
107 See id. art. 14.
108 See id. art. 14(1).
within their borders subject to any authorization requirements. The investment firm previously authorized by its home Member State does not need to incorporate a subsidiary in the host state or satisfy any further licensing requirements of the host state. This holds true even though the authorization requirements of the host state are considerably more rigorous than those of the home state that granted the investment firm's authorization. The authorized investment firm desiring to commence business operations in other Member States need only comply with the Directive's relatively simple notification requirements.

The Directive requires, in essence, that a previously authorized investment firm simply notify the competent authority of the home state of its plans to establish a branch or provide services in another Member State. The home state will then notify the intended host state of the firm's plans to establish a branch or otherwise provide previously authorized investment services in the host state. For the establishment of a branch, the firm must either receive a notice from the host state or wait two months following the home state's notice. For the provision of services in the host state without the establishment of a branch office, the investment firm may commence its business in the host state immediately following the home state's notice to the host state.

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109 See id. art. 14(2). The mutual recognition required by the Directive is subject to a potentially far-reaching obstacle in the form of host state imposition of laws protecting the "general good." Id. pmbl. See also id. art. 13 (regarding host state "general good" regulation of advertising); id. arts. 17, 18(2) (regarding the host state's imposition of "general good" conditions in addition to conduct of business rules); id. art. 19(6) (regarding host state enforcement of "other legal or regulatory provisions adopted in the interest of the general good"). Under EU jurisprudence, however, "general good" regulations applied by host states must be proportionate, non-discriminatory and non-duplicative of home state regulation. See Redhead, supra note 3, at 188 & n.13; Warner, supra note 3, at 17-19.

110 See Investment Services Directive, supra note 2, arts. 17, 18.
111 See id. art. 17(1), (2).
112 See id. art. 18(1).
113 See id. arts. 17(3), 18(2).
114 See id. art. 17(4).
115 See id. art. 18(2).
3.5. **Prudential Rules**

The Directive establishes a common set of minimum financial soundness standards, referred to as prudential rules, applicable to all authorized investment firms.\(^{116}\) Each Member State, in its role as the home state of the investment firms it has authorized, is required to impose and supervise compliance with these rules.\(^{117}\) The Directive requires that each home state draft and enact rules which require, among other things, that each authorized investment firm complies with the following:

1. The firm must have sound administrative and accounting procedures;
2. The firm must maintain controls and safeguards over electronic data processing;
3. The firm must have adequate internal control mechanisms, including rules for personal transactions by its employees;
4. The firm must safeguard investors’ rights in their securities and funds, and, more particularly, it must have arrangements for segregation of accounts to prevent the firm from using investors’ securities and funds for its own account (except funds held by banks);

\(^{116}\) See *id.* art. 10.

\(^{117}\) See *id.* art. 8(3). The Commission recently has proposed an amendment to the Investment Services Directive intended to facilitate prudential supervision of investment firms by the competent authorities of the Member States. See Proposal for a Council Directive Amending Directive 93/22 in the Field of Investment Firms in Order to reinforce Prudential Supervision, 1993 O.J. (C 229) 10, COM (93) final - SYN 468. The amendment, precipitated in part by the Bank of Credit and Commerce International (“BCCI”) scandal, would require disclosure of group structure by investment firms belonging to a group of affiliated entities in order to allow effective supervision. See *id.* pmbl. and arts. 1, 2, 4. A “group” is defined as two or more companies that are linked by “participation,” meaning the ownership of at least 20% of voting rights or capital, or by “control.” See *id.* art. 1. In addition, the proposal would require auditors to report to competent authorities any matters which are likely to endanger the investment firm or its clients or which involve violation of sound management principles. See *id.* art. 5. See also EC Proposes Amendments to Several Financial Directives, 6 Int'l Sec. Reg. Rep. (Buraff) No.19, at 2 (Aug. 14, 1993).
(5) the firm must maintain records of all transactions sufficient to enable the home state's competent authority to monitor compliance; and
(6) the firm must be structured and organized in a manner sufficient to minimize the risk of conflicts of interest between the firm and its clients.\textsuperscript{118}

In its first discussion draft of the Directive,\textsuperscript{119} the Commission originally characterized these rules as conduct-of-business rules rather than prudential rules, but they were nevertheless to be administered by the home state of authorized investment firms. The imposition of supervisory responsibilities on the home state, rather than the host state, with respect to the segregation and conflict-of-interest rules which clearly implicate a firm's business conduct in the host state, is likely to generate considerable enforcement problems.

Moreover, the Directive provides no common private cause of action to investors for breach of the home state's prudential rules or the host state's non-uniform conduct-of-business rules. Although the Directive authorizes the Member States to adopt penalties and other measures to enforce the regulations applicable to investment firms,\textsuperscript{120} it fails to specify remedial measures necessary to protect aggrieved investors. Shortly before adoption of the Directive, an attempt was made to include a requirement that each investment firm participate in the host state's investor compensation fund, with contribution amounts to be calculated on the basis of income derived from investment services provided by the firm in the host state.\textsuperscript{121} The EU Commission did not support these last-gasp efforts to protect retail investors, preferring to

\textsuperscript{118} See id. art. 10. In establishing minimum standards, the directive permits a home state to adopt rules that are stricter than those provided. See id. pmbl.

\textsuperscript{119} See EC Discussion Draft, supra note 83, at 6. Some commentators have expressed concern that home states might adopt various measures, under the guise of prudential rules, in order to achieve home state regulation of conduct of business through the back door. See Redhead, supra note 3, at 204.

\textsuperscript{120} See Investment Services Directive, supra note 2, art. 27.

submit to the Council of Ministers its own proposal for a separate directive to harmonize compensation systems among the Member States. The Investment Services Directive requires only that investment firms disclose to investors whether and to what extent a compensation fund or equivalent protection is afforded, if at all. For the time being, investors and their newly-integrated marketplace will suffer from the absence of any remedial commonality among the Member States.

3.6. Conduct-Of-Business Rules

The Directive does not establish common minimum conduct-of-business rules for investment firms, primarily because the development of rules for the protection of investors threatened to derail progress towards adoption of the entire Directive. Considerable differences among Member States emerged as to the coverage of these kinds of rules and their manner of application. The United Kingdom's Law Society, in comments concerning the draft Directive, stated:

We think it is premature to attempt to harmonise conduct of business rules and it would have a disastrous effect on the timetable for the implementation of the directive if attempts were made now. We are of the view that these matters should be left for a further directive. We therefore see no alternative at the present time but for the directive to leave such rules as a matter for the host state, thus

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122 See Investment Services Directive, supra note 2, art. 12 (codifying the Commission's commitment to propose an investor compensation directive that would be transposed into the national laws of the Member States at the same time as the Investment Services Directive). In accordance with this commitment, the Commission recently approved a proposed directive for adoption by the Council of Ministers. See Directive to Require Mandatory Securities Compensation Schemes, 6 Intl Sec. Reg. Rep. (Buraff) No. 21, at 5 (Oct. 5, 1993). The proposal requires each investment firm to participate in its home state's compensation system, with coverage for both the firm's home state and host state clients at a minimum level of ECU 20,000 ($23,500) in the event of the firm's insolvency or its inability to return investors' funds or securities. See id.

123 Investment Services Directive, supra note 2, art. 12.

124 See Nicoll, supra note 3, at 2.

125 See Bradley, supra note 3, at 552.
leaving it open for a host state to apply its conduct of business rules in its own market as regards investment firms authorized in another Member State, even though those rules may be more stringent than those operating in the investment firm’s home state.\(^\text{128}\)

Thus, development of harmonized conduct-of-business rules has been deferred by the Commission. In lieu of specific, detailed conduct-of-business rules, the Directive sets forth seven common principles.

Member States are required to draw up and enact conduct-of-business rules incorporating the following general principles:

(1) The firm must act honestly and fairly in conducting its business activities in the best interests of its clients and the integrity of the market;
(2) the firm must act with due skill, care, and diligence;
(3) the firm must employ the resources and procedures necessary for proper performance of its business activities;
(4) the firm must obtain from its clients information as to their financial position, investment experience, and objectives;
(5) the firm must make adequate disclosure of relevant material information in its dealings with clients;
(6) the firm must try to avoid conflicts of interest and, when they exist, must ensure the clients’ fair treatment; and
(7) the firm must comply with all regulatory requirements applicable to its conduct of business.\(^\text{127}\)

While compliance with these prudential rules is to be supervised by the home state, compliance with the conduct-of-business rules is to be supervised by the host state.\(^\text{128}\) Until

\(^{126}\) Law Society Comments, supra note 62, at 15.
\(^{127}\) Investment Services Directive, supra note 2, art. 11(1).
\(^{128}\) See id. art. 11(1), (2). The Member States are required to apply their conduct of business rules “in such a way as to take account of the professional nature of the person for whom the service is provided.” Id. art. 11(1). See also id. art. 11(3).
these conduct-of-business rules are harmonized by a separate directive, twelve different sets of conduct-of-business rules will be adopted by Member States and applied by each host state. According to one investment firm executive, this scheme will result in a "compliance nightmare," with investment firms struggling to familiarize themselves with rule variations among the twelve Member States. It must be noted that this "nightmare" predated the Directive. It should be relieved somewhat by the implementation of common guiding principles and, ultimately, by the adoption of a conduct-of-business rules directive. Even with the harmonizing impact of a comprehensive directive, however, the EU regulatory scheme enforced by host states will be fragmented by scope and stringency variations and by the range of enforcement intensity among the Member States.

3.7. Access To Stock Exchanges

In one of its more hotly-contested provisions, the Directive provides expanded ability for investment firms and banks authorized by their respective home states to become members of the regulated markets of the host states. Firms authorized to act as brokers or dealers by their home states must be allowed the free choice of becoming members of, or having access to, the host states' regulated markets. This access must be either "directly," by setting up branches in the host states, or "indirectly," by incorporating subsidiaries in the

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129 Robert K. Steel, European Securities Markets—The Way Ahead, Paper Presented at Financial Times Conference, London, England, May 10, 1993, at 3. Apparently, the investment banking community preferred home state control over authorization, prudential rules and conduct of business rules. Id. Thus, an investment firm engaged in cross-border activities would be subjected to only one set of rules—those of its authorizing home state. In other words, in the absence of harmonization of rules throughout the EU, at least single firm harmonization could be achieved. This arrangement, of course, could wreak havoc among investors and regulatory authorities in the host states, who would confront their own nightmare in determining which rules applied to each of the various investment firms operating in the same host state market. The "compliance nightmare" is likely to become even more frightening as a result of host state imposition of various "general good" regulations in addition to its formalized conduct of business rules. See supra note 108.

130 See Global Harmonization, supra note 1, at 231.

131 See Investment Services Directive, supra note 2, art. 15.
host Member States or by acquiring firms which are already members of the host states’ regulated markets or already have access to those markets.\textsuperscript{132} If the host state’s regulated market has numerical limitations on exchange membership, the host state must abolish those restrictions or adjust them to satisfy demand.\textsuperscript{133} The expanded access provided by the Directive also extends to the clearance and settlement systems provided for members of host states’ regulated markets.\textsuperscript{134}

Credit institutions, unlike other investment firms, are denied direct access until various transitional periods have expired. The Directive provides for variable speeds of bank access by establishing a staggered timetable for giving banks direct access to the domestic stock exchanges of those Member States not permitting direct bank access but requiring separately capitalized investment firm subsidiaries. France, Italy and Belgium are allowed to deny access until December 31, 1996, and Spain, Greece and Portugal are permitted to extend that period until December 31, 1999.\textsuperscript{135} These extensions accommodate the Club Med’s understandable opposition to Germany’s desire for direct bank access to the domestic stock exchanges of the other Member States.\textsuperscript{136} Prior to reaching the compromise of transitional effectiveness, the Club Med group insisted that Member States should be allowed to require all banks to incorporate and separately capitalize investment firm subsidiaries as a precondition to access to their domestic stock markets. When the Directive finally becomes fully effective for banks, it should prove particularly beneficial to French and German universal banks, which are already authorized by their home state authorities to provide investment services. Not only will those banks be free of any requirement to obtain additional authorization in

\textsuperscript{132} Id. art. 15(3).
\textsuperscript{133} Id. art. 15(1). The opportunity for banks to become members of host state regulated markets directly, without incorporating separate subsidiaries, is hailed by the Directive as “a significant reform.” Id. pmbl.
\textsuperscript{134} Id. art. 15(1).
\textsuperscript{135} Id. art. 15(3).
\textsuperscript{136} See Dassesse, supra note 3, at 7. Professor Dassesse has concluded that Germany, with all of its finance and universal banks engaged in banking and investment services activities under one roof, joined the North Sea Alliance in order to protect the direct access of its banks to the regulated markets of the other Member States. Id. at 5, 7.
other Member States, but they will also have direct access to membership in the regulated markets of the other Member States, even if those host states do not provide similar access for their own domestic banks.

The liberalized access provided by the Directive is further enhanced by a provision allowing cross-border access through electronic facilities,\textsuperscript{137} bringing markets closer to "the end of geography."\textsuperscript{138} In cases where a host state's regulated market does not require a physical trading floor, the Directive requires that investment firms be permitted to become members or have access to that host state's regulated market through remote electronic terminals.\textsuperscript{139} To ensure this cross-border access, the Directive obligates home states to allow the host state's regulated market "to provide appropriate facilities within the home Member States' territories."\textsuperscript{140} Accordingly, in such cases, the home state of the prospective member firm must allow local installation in its territory of the required hardware and software systems to enable the firm to transmit business across borders through the host state's regulated market. This provision is likely to have significant ramifications for the United Kingdom and its floorless, screen-based International Stock Exchange and SE AQ International. British authorities have conceded that this provision would prevent imposition of their 1986 Financial Services Act

\textsuperscript{137} Investment Services Directive, supra note 2, art. 15(4).

\textsuperscript{138} Glenn Whitney, Taking Stock: Turmoil in Europe's Financial Markets Will Produce Both Big Winners and Losers, WALL ST. J., Feb. 3, 1993, (supp. section) at R3. According to Richard O'Brien, chief economist at American Express Bank in London, "Europe is the example par excellence of the end of geography. . . . Unlike in the rest of the world, there are strong political forces bringing the economies together." \textit{Id.} Thus, the particular geographic location of a market and its particular nationality—if it has one at all—may become insignificant. Moreover, electronic off-exchange proprietary trading systems, already developed in the wholesale Euromarkets, are "standing free" markets, free from the constraints of geography, politics, and regulation. They are likely to proliferate. Whether and how these markets can be captured by national or international regulatory systems are issues that must be resolved. According to one writer, if international regulatory cooperation is not achieved because exchanges and their governments remain "stuck behind national boundaries," securities business will move to newly-developing proprietary trading systems. \textit{The Battle of the Bourses}, ECONOMIST, Feb. 1, 1992, at 82.

\textsuperscript{139} See Investment Services Directive, supra note 2, art. 15(4).
authorization requirements on other Member States' stock exchanges operating through remote terminals in the United Kingdom.\textsuperscript{141}

Although the Directive frees authorized investment firms from having to obtain host state authorization, it does impose certain regulatory conditions on those firms in connection with securing membership in or access to the host states' regulated markets. Investment firms from other Member States must comply with the rules concerning transactions in that host state market, including the applicable professional standards.\textsuperscript{142} In addition, these firms must comply with the rules and procedures for clearing and settlement of securities trades.\textsuperscript{143} The absence of harmonized clearance and settlement mechanisms in the EU continues to pose a severe restraint on the full integration of the EU securities markets and on the internationalization of securities markets generally.\textsuperscript{144} The Commission should assign the highest

\textsuperscript{141} DTI CONSULTATIVE DOCUMENT, supra note 44, at 23.

\textsuperscript{142} Investment Services Directive, supra note 2, art. 15(2) ("Access to a regulated market, admission to membership thereof and continued access or membership shall be subject to compliance with . . . the professional standards imposed on staff on and in conjunction with the market.").

\textsuperscript{143} Id.

\textsuperscript{144} Clearance and settlement procedure has been described as "the black spot of European securities." Capital Markets Survey, supra note 48, at 27. According to one study, the absence of automated clearance and settlement systems for international equity transactions has limited the flow of equity capital across national borders. SEC STUDY, supra note 25, at II-57. Whether these systems are standardized and integrated is critical to the globalization of the world's securities markets. Id. at V-61. The major problems result from a lack of international clearance and settlement cross-border linkages and the existence of widely-varying clearance and settlement procedures in the world's securities markets. Id. See generally David E. Van Zandt, The Regulatory and Institutional Conditions for an International Securities Market, 32 VA. J. INT'L L. 47 (1991); Richard P. Bernard, International Linkages Between Securities Markets: "A Ring of Dinosaurs Joining Hands and Dancing Together"?, 1987 COLUM. BUS. L. REV. 321 (1987); Samuel E. Hunter, The Status and Evolution of Twenty-Four Hour Trading: A Trader's View of International Transactions, Clearance, and Settlement, 4 B.U. INT'L L.J. 15 (1986).

The settlement system of the Member State with the most developed international securities market, the United Kingdom, has been described as "one of the worst settlement systems in the developed world." What is a Stock Exchange For?, ECONOMIST, Mar. 13, 1993, at 93. After six years of work and an estimated $600 million of costs, London's International Stock Exchange recently scrapped its never-completed Taurus computerized
priority to the elimination of this barrier to market integration.

3.8. Concentration And Off-Market Trading

The issue that proved the most troublesome in achieving Member State consensus on the Directive was the issue of "concentration." Basically, the term refers to a requirement that trades in a given security must be executed solely on the regulated market of a Member State where that security is listed, to the exclusion of off-market execution in an unregulated market. The concentration issue, as well as the related transparency issue, was proposed by the French, and, as a result, the debate over the Directive was expanded from its central theme of market access through mutual recognition to include the more contentious and divisive themes of market structure and regulation.145

France, with the support of its Club Med Member States, insisted on a concentration requirement as a way to ban lightly-regulated, quote-driven, screen-based markets, including London's SEAQ International and the London-based off-exchange Eurobond market, in favor of the more tightly-regulated, order-driven, floor-based markets on the continent. The Club Med countered that this restraint on free markets was necessary to protect widows, orphans and other retail investors, to which one critic replied: "How touching. The simpler truth is that southern Europeans want to protect their exchanges from competition."146 One commentator recently observed that the "reluctance on the part of the Paris market to encourage off-exchange trading at the expense of the highly regulated retail [exchange] markets is related to the apprehension among Europe's exchanges that London's SEAQ I[nternational] will run them out of business even sooner

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145 See Pan-European Markets, supra note 55, at 86.
under the [Investment Services Directive's] passport system.”147 In the end, the North Sea Alliance’s fierce opposition, led by the British and Germans, resulted in a substantially watered-down version of the concentration proposal.

The final version of the concentration requirement does permit a Member State to require that securities transactions be carried out on a “regulated market,”148 which is defined by the Directive as a market designated by a Member State on a prescribed list of approved exchanges that functions regularly and complies with the Directive’s minimum reporting and transparency standards and the listing standards imposed by the Admission Directive.149 The concentration requirement is significantly weakened, however, by the requirement that four conditions be satisfied before the rule may be applied by a Member State:

(1) The investor must be “established” or be a continuous resident of that Member State;150
(2) the transaction must be executed by the investment firm through its main office, through a branch located in that Member State or under the freedom to provide services in that Member State;151
(3) the transaction must involve securities that are actually listed on a regulated market in that Member State,152 and
(4) the investor must not have exercised the right granted by the Directive to opt for an off-exchange market.153

147 Houghton, supra note 3, at 772.
148 Investment Services Directive, supra note 2, art. 14(3).
149 Id. art. 1(13).
150 Id. art. 14(3).
151 Id.
152 Id.
153 Id. art. 14(4). The Directive requires each Member State to afford investors, who are “habitually resident” or established in that Member State, the right not to comply with the concentration requirement, thus permitting those investors to have transactions executed in non-regulated markets. Id. Nonetheless, Member States are authorized to condition investor opt-out rights on “express authorization,” and, in doing so, they are to consider the differing needs for protection among retail, professional and institutional investors. Id. It is unclear whether Member States could
The opt-out provision obviously represents a vital feature of the Directive's concentration rule. In preserving investor choice, the opt-out clause protects retail investors in their efforts to achieve best execution in a competitive market environment. Moreover, it protects the professional and institutional investors' access to wholesale, off-exchange markets. Investor choice, however, requires regulatory reassessment. While the British were arguing strenuously for the preservation of market choice, the United Kingdom's Department of Trade and Industry expressed concerns that "some member states appear to have no regulatory oversight of off-market transactions." It would be a disaster laced with irony if the EU's effort to integrate its regulated securities markets resulted in a mass exodus to a "wild west" of opaque markets free of regulatory scrutiny.

The most virulent criticism of the diluted concentration provision has come from participants in the Eurobond market, which has an estimated annual turnover in its secondary market of approximately $9 trillion. They fear that investors' ability to opt out may be complicated by Member State restrictions, and, accordingly, they would have preferred a specific exemption from the Directive. Unlike SEAQ International, which is likely to be designated a "regulated market," the Eurobond market is not a regulated market and clearly falls outside the Directive's definition. It has been suggested that Member States "could use the directive to boost business levels on domestic exchanges through a strict interpretation of the measures and insistence that retail bond

require an investor's written opt-out for each trade, as opposed to a blanket authorization, but the Directive does state that any required authorization must "not jeopardize the prompt execution of investors' orders." Id.

164 DTI CONSULTATIVE DOCUMENT, supra note 44, at 24.
166 Id. See also Olivia P. Adler, Progress on EC Capital Adequacy and Investment Services Directives, 5 Intl Sec. Reg. Rep. (Buraff) No. 18, at 6 (Aug. 11, 1992); Steel, supra note 129.
167 Telephone Interview with Paul Smee, Head of Public Policy and International Relations, London Stock Exchange (Nov. 8, 1993).
168 See London Observers, supra note 155, at 3.
business be conducted on a regulated market.” Although this suggestion is unlikely to be implemented, it is hard to disagree with the conclusion that the Directive has created “unnecessary legal uncertainty” for the Eurobond market.

3.9. Transparency

Clearly related to the concentration rule—and equally controversial—is the Directive’s creation of minimum transparency rules for the regulated markets of the Member States. As originally proposed by the French and supported by the Club Med Member States, the combination of concentration and transparency rules would have forced investors to conduct their securities trades in “transparent” regulated markets. The French proposed detailed transparency rules, which would have required the immediate disclosure of price and volume information for all regulated market securities transactions. The Club Med advanced the position that stringent transparency rules were critical to ensuring an adequate level of investor protection and reducing risks of distortion among competitive markets. Most commentators have concluded, however, that the underlying motivation for the concentration and transparency rules was “swiping business both from SEAQ International and from free-wheeling international bond dealers.” The British and Germans, backed by the North Sea Alliance, insisted that limited secrecy regarding trading transactions was essential to the protection of market makers transacting business in quote-driven, off-exchange wholesale markets dominated by professional and institutional traders, markets where transparency may be less important than liquidity. They

\[159\] Id.
\[160\] Id.


\[162\] See Houghton, supra note 3, at 773-74.

\[163\] Europe’s Share Markets: Brussels Babble, ECONOMIST, June 1, 1991, at 78.

\[164\] See Capital Markets Survey, supra note 48, at 28. According to one writer, “liquidity and transparency are often trade-offs,” given the preference of institutional investors for liquidity sufficient to execute large trades and retail investors’ desire for full disclosure. Id. See also Poser,
argued that "the immediate release of detailed information regarding securities transactions would adversely affect the liquidity of their trading firms." In the end, a compromise was reached that resulted in delayed transparency, thus ameliorating fears that the French proposal would "regulate away existing markets." As finally adopted, the Directive requires the competent authorities of each Member State to adopt for their respective regulated markets the following minimum transparency rules:

(1) Publication at the market opening of the weighted average price, the high and low prices, and the volume during the preceding day of each security traded on the regulated market, and

(2) publication, based on a two-hour calculation period, of the weighted average price and the high and low price after a one-hour delay, to be updated every twenty minutes until the market closes.

Assuming a 9:00 a.m. opening, the weighted average price, the high and low prices and the volume during the preceding day must be published at the commencement of the trading day. The current day's weighted average price as well as the high and low prices for the period 9:00 a.m. to 11:00 a.m. must be published at 12:00 p.m. and updated every twenty minutes thereafter to cover a two-hour period on a one-hour delayed basis. The Directive leaves to Member State discretion the means of dissemination. In addition, the Directive permits Member States to exclude from their transparency rules transactions involving large blocks of securities and illiquid securities and to apply "more flexible provisions" for transactions involving bonds and other forms of securitized debt. In stark contrast to the U.S. securities markets' real-
time reporting standards, the Investment Services Directive's market transparency standards are remarkably opaque. If true integration of the Member States' securities markets into a single "Euromarket" is to be achieved, both regulators and market participants should seriously pursue the development of a "Eurotape," providing real-time reporting on a consolidated basis of all transactions in the EU's publicly-traded securities.

3.10. Reciprocity For Non-EU States

The Investment Services Directive does answer "fortress Europe" claims that the EU will somehow manage to exclude the United States, Japan and other non-EU states from the single passport scheme. Access for outsiders was one of the issues discussed most during the debates concerning the Second Banking Directive. As a result, this battle did not have to be fought again with the Investment Services Directive. As originally proposed, both directives arguably required strict or "mirror image" reciprocity. In other words, the initial proposals conditioned reciprocity on non-EU states providing EU firms with competitive opportunities equivalent to those afforded in the EU. This condition would have denied U.S. banks the benefits of the EU's single market because U.S. law does not authorize universal banking. Due to this limitation, U.S. commercial banks may not engage in the underwriting of securities distributions, and they may not offer various other investment services that EU banks are allowed to provide. Ultimately, the objections of the United States persuaded the EU to adopt a "national treatment" approach in the Second Banking Directive, "a substantial achievement for United States financial diplomacy and a substantial step towards international free trade in services."

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172 See supra note 40.
173 Levitin, supra note 171, at 507. Conversely, pending legislation supported by the Clinton administration would permit the United States to block expansion of foreign banks and investment firms into the United States if it is determined that the home state of those firms restricts access of U.S. firms. See Kenneth H. Bacon, Bentsen Wants Law Aiding U.S. Banks and Other Financial Firms Overseas, WALL ST. J., Oct. 26, 1993, at https://scholarship.law.upenn.edu/jil/vol15/iss2/1
To satisfy the national treatment condition imposed by the Investment Services Directive, the non-EU country must afford EU investment firms the same competitive opportunities available to domestic investment firms.\textsuperscript{174} The Directive does provide for continuing review to determine whether non-EU states are providing national treatment and "effective market access" to EU firms.\textsuperscript{175} If the Commission should determine that such treatment is not being afforded EU firms, it is empowered by the Directive to negotiate with the offending non-EU state and to limit or suspend both authorization of EU subsidiaries of that country's firms and acquisitions by that country's firms of previously authorized EU firms.\textsuperscript{176} Despite the notable improvements in the Directive's third-country reciprocity provisions, concerns remain as a result of the Commission's considerable discretion in interpreting the ambit of the terms "national treatment" and "effective market access" as used in the Directive.\textsuperscript{177} Of course, even with reciprocity, non-EU firms, unlike Member State firms, suffer the disadvantage of having to incorporate and capitalize an EU subsidiary separately in order to secure the benefits of the single passport.

Fortunately, the Directive does incorporate a grandfather clause for investment firms already authorized by a Member State to provide investment services before December 31, 1995.\textsuperscript{178} EU subsidiaries of non-EU firms that have obtained authorization prior to the effective date of the Directive are thus automatically entitled to authorization under the Directive and permitted to use the EU single passport. This entitlement is particularly advantageous to the major investment banks in the United States, most of which have incorporated investment firm subsidiaries in one or more Member States during the past decade or earlier.

\\textsuperscript{174} Investment Services Directive, \textit{supra} note 2, art. 7.

\textsuperscript{175} \textit{Id.} art. 7(3).

\textsuperscript{176} \textit{Id.} art. 7(5).

\textsuperscript{177} See Reid & Ballheimer, \textit{supra} note 3, at 122.

\textsuperscript{178} Investment Services Directive, \textit{supra} note 2, art. 30.
4. Conclusion

The Investment Services Directive is to be enacted by each of the Member States into their respective laws on or before July 1, 1995, and these laws must become effective no later than December 31, 1995.\(^{179}\) Like all other EU legislation in directive form, the Investment Services Directive does not require verbatim enactment by the Member States; rather, it requires national legislation which achieves the same result.\(^{180}\) This latitude accorded the Member States virtually always results in significant substantive variations from state to state, and, accordingly, an overall scheme which is hardly harmonious. In addition, the national laws that are adopted will be enforced in widely-varying degrees of intensity. The success of the Directive depends largely on a convergence of the Member States’ regulatory philosophies, attitudes and commitments as well as vastly improved interstate regulatory cooperation.\(^{181}\) Although a securities committee would promote that cooperation,\(^{182}\) the necessary convergence

\(^{179}\) *Id.* art. 31.

\(^{180}\) The Treaty of Rome states that “[d]irectives shall bind any Member State to which they are addressed, as to the result to be achieved, while leaving to domestic agencies a competence as to form and means.” *Treaty of Rome*, supra note 4, art. 189.


\(^{182}\) An EU mandate for cooperation between the Member States and the Commission in the application and development of EU law eventually may result in significant further achievements in the integration of the EU’s securities markets. The EU principle of comitology requires consultation by the Commission with a committee of experts from the Member States in the development of community legislation. *See* Council Decision 87/373, 1987 O.J. (L 197) 33. Thus, the Investment Services Directive insists upon cooperation between the Commission and the Member States in addressing problems that arise in the application of the Directive and proposals for closer coordination in the future. Investment Services Directive, *supra* note 2, pmlbl. The Directive requires the Commission, after consultation with a Securities Committee, to propose amendments necessary to address new developments in the investment services field. *Id.* art. 29.

The Securities Committee, to be created by a separate directive and to be comprised of representatives from each Member State and the Commission. The Committee will: (1) assist the Commission in developing https://scholarship.law.upenn.edu/jil/vol15/iss2/1
remains in the realm of hopes and dreams. Moreover, the regulations of the EU's emergent single market will not be guided by a centralized regulatory agency with EU-wide jurisdiction. There have been numerous calls for its creation, but no Euro-SEC currently exists or is likely to exist in the foreseeable future. 183

Despite this and other criticisms discussed in this Article, the Investment Services Directive does represent a remarkable advance toward regulatory harmony and more accessible securities markets in the Member States. It should lead to substantial uniformity among the twelve Member States as to authorization standards, financial soundness and related prudential rules, and, ultimately, to roughly equivalent conduct-of-business rules. In a victory for financial nationalism, the Directive did not succeed, as it might have, in altering the structure of the various domestic markets. These markets remain not integrated but fragmented. This outcome particularly favors London's SEAQ International and the Euromarkets based there. The Directive's new transparency rule, perhaps better described as an "opacity rule," and the critical "opt-out" escape hatch from the concentration

technical adaptations to both the Investment Services and Capital Adequacy Directives, (2) advise the Commission on matters related to the application of the directives, (3) advise the Commission in developing new proposals in the securities field and (4) serve as a vehicle for continuous cooperation between the Commission and the competent authorities of the Member States. See Ruben Lee, Securities Regulation in the EC: Some Problems and Solutions, 6 Int'l Sec. Reg. Rep. (Buraff) No. 19, at 9, 10 (Aug. 24, 1993).

requirement which accompanied it, should preserve London's continued dominance over its continental competition. Finally, the Directive's mutual recognition provisions, providing, in effect, a single multistate license, should greatly facilitate EU-wide operations for investment firms and, hence, significant integration and efficiency improvements. The extent of this integration, while hardly creating a true, single market, should serve as a powerful catalyst for the eventual development of a European securities market system.