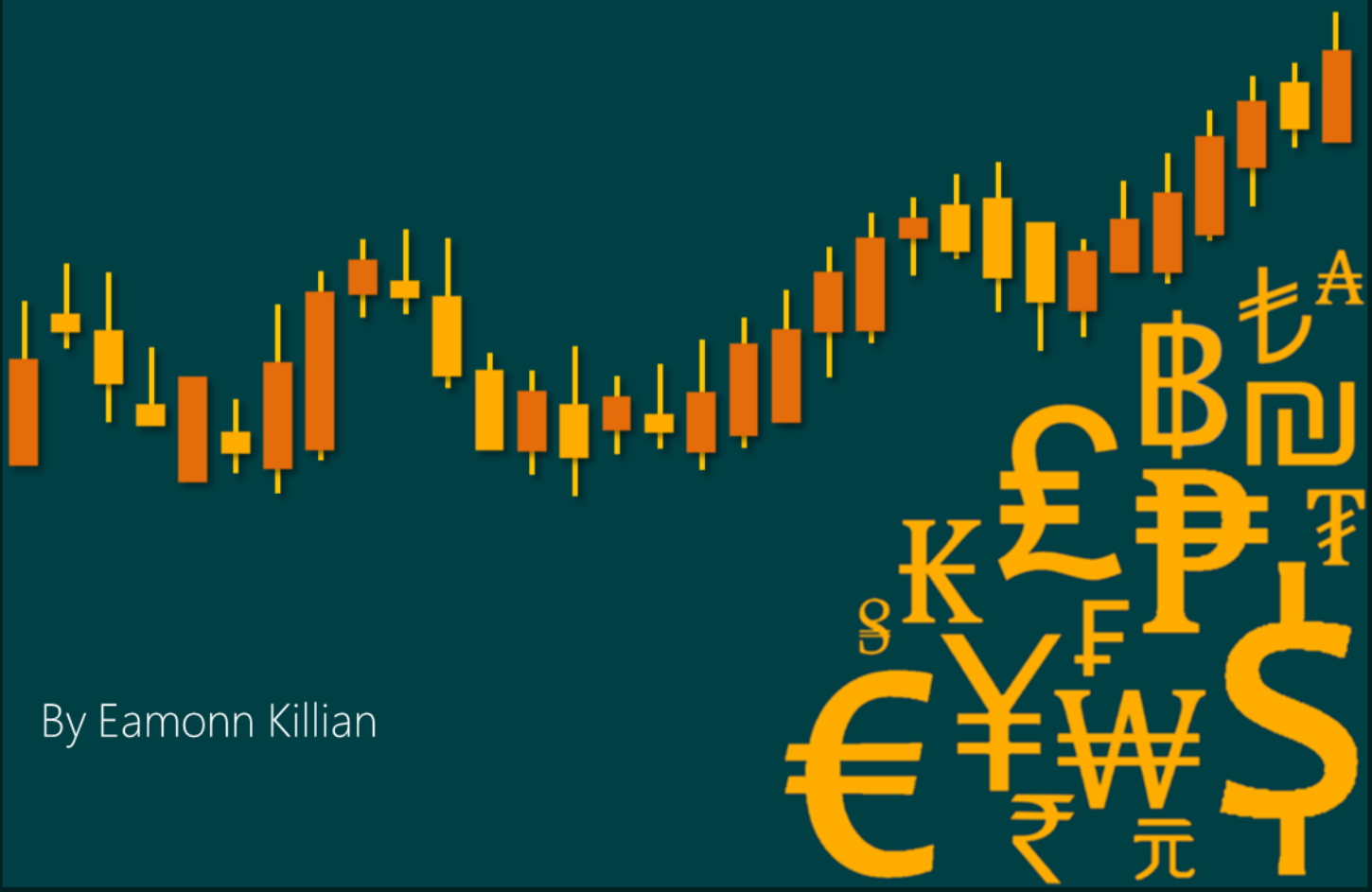
A Coffee Shop Read

Capital, the EU & the Global Financial Crisis

A modern day excuse for the *anschluss* of financial regulation and supervision by the European politocracy?

This "Coffee Shop Read" provides an investigation of the free movement of capital, its closeness to sovereignty, the previous EU regulatory experiences, the operative mechanisms necessary to regulate and supervise financial services, and then the utilisation of that investigation as the basis for a hypothesis based approach to examine the renewed drive by the Commission to centralise the management of financial risk across the EU set against the key dimensions of certainty, coherency, competency, and sovereignty.



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Dedicated to Jo, Amy, Eryn & Ethan who put up with my near constant hours of studying and writing.

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Abstract

The free movement of capital within the EU is the laggard freedom, perhaps emanating from its ill-bounded contingent character as drafted in Article 67 of the original Treaty, or being ruled as not directly effective, or its close proximity to sovereignty and subsidiarity considerations. Clearly there must be significant operational inhibitors, as well as political considerations which have frustrated efforts (from Segrè and Werner onwards) to remove the barriers and emancipate the flows of capital.

Recent events however, serve to highlight the fragility of our predicament on the global financial stage with significant systemic risks emanating from the globalisation of capital and foreign direct investment. The Commissions answer is to centralise EU regulation with the introduction of new supranational authorities whose binding powers and remit is to drive forward the harmonisation of financial regulation and supervision.

Perhaps we've heard this before? As the purposefully incendiary title suggests this dissertation shall investigate the importance of capital, its closeness to sovereignty, the previous EU regulatory experiences, the operative mechanisms necessary to regulate and supervise financial services, and utilise a hypothesis based approach to examine the renewed drive by the Commission to centralise the management of financial risk across the EU set against the key dimensions of certainty, coherency, competency, and sovereignty.

Contents

1. Introduction

The threads of origin are numerous, from famous speeches to coordinated conventions all exhibiting an underlying commonality, that of a united Europe sharing its common inheritance in the pursuit of happiness, prosperity and glory for its 400 million peoples. [1] Whether this reluctant bride and her mature politically astute suitor [2] foresaw the degree of metamorphosis that was to unfold is unknown. The codified output of their union in the form of the original Treaty of Rome [3] provides clarity as to their objectives. Articulated in Article 3, are the ambitious goals, the economic basis of which was the theory of comparative advantage [4] and the fiscal stimulus derived from the "liberalization of factors of production allow[ing] for the optimum allocation of labour and capital". [5] In the case of the European Union (EU) the difference is that this seemingly ordinary international agreement, by law, created supranational bodies [6] with conferred powers to be used in the pursuit of those aims embodied in the Treaty. [7] Over time these supranational bodies have exerted a broad influence over the evolution of the EU and its constituent Member States (hereinafter MS), leading to claims of a growing sense of democratic deficit [8], of usurpation of the democratic system [9], and arguably, to the rise of a self-sustaining European politocracy [10]; exemplified through the European Commission (hereinafter the Commission), the European Council, the European Court of Justice (ECJ), and the European Parliament.

The core requirement was the development of a mechanism for the so-called four freedoms [11]; specifically the freedom of movement of goods, labour, services and capital; to flourish. Classic theories of economic integration tend to emphasize negative integration, the removal of

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[1] http://www.ena.lu/ 'Winston Churchill, Metz, 14th July 1946' (accessed 25-07-2010)
[2] D Halberstam, 'The Bride of Messina: constitutionalism and democracy in Europe' (2005) ELRev 776
[3] http://eur-lex.europa.eu/en/treaties/index.htm 'Treaty Establishing the European Economic Community (1957)' (accessed 28-05-2009)
[4] C Barnard, *The Substantive Law of the EU* (2nd ed., Oxford University Press, Oxford, 2007) pp.3-8
[5] See n 4 above 10 [ing] added
[6] T Hartley, 'The Constitutional Foundation of the European Union' (2001) 117 LQR 225
[7] A Soares, 'The Principle of Conferred Powers and the Division of Powers Between the European Community and the Member States' (2001) Liverpool Law Review 57-58
[8] P Pescatore, 'The Doctrine of 'Direct Effect': An Infant Disease of Community Law' (1983) 8 ELRev 155
[9] D Ward, *The European Union Democratic Deficit and The Public Sphere* (IOS Press, Amsterdam, 2004) 1-12
[10] The term politocracy refers to a form of political oligopoly, where it is asserted that politicians work primarily for the party interests above those of the electorate. In the context of this paper it is taken as the collective description for the European Council, European Commission, European Court of Justice, and the European Parliament who, it could be argued, are dedicated to the interests of the Treaty above those of the electorate; See B Denitch, *The End of the Cold War* (University of Minnesota Press, Minneapolis, 1990) 47; F Tampoe, *Plutopolitocracy, the reality of modern democracy* (Troubador, Leicester, 2009) 21
[11] See n 4 above 10

barriers to trade in terms of tariffs, quotas and the like[12] and this indeed became the Commission's initial focus, namely the eradication of tariff and quota barriers through the mechanism of harmonisation of laws across the MS, with any expression of doubt in favour of cultural diversity, any critique of a centralising legal integration processes being rapidly construed as inimical to the grand European project. [13] While customs tariff eradication was successful by the end of the transition period[14], the Commission continued to toil with further harmonisation throughout the 1970's, the fruits of which were few, with negotiations coming to a standstill in the Council of Ministers, and the passing of legislative measures hampered by the unanimity requirements of Article 100 (now Article 115 TFEU[15]). By 1985 the Commission was in crisis, vituperated by its outgoing President as fettered by jealous national structures, incapable of achieving its declared Treaty objectives[16], and lacking a clear political direction[17]. Despite these criticisms significant advances had come about, not by capricious chance and legislative advancement, but by deliberate determinism that characterised from the outset the holistic and activist approach of the European Court of Justice (ECJ) in seminal rulings beginning with Van Gend[18], continuing through Costa[19], reinforced in Defrenne[20], and bolstered through Francovich[21] which had established a complete system of Community law and implied the creation of an entire legal framework leading ostensibly to the constitutionalisation of the Treaties. [22]

The successful implementation of the Treaty's freedoms undoubtedly emanate, in no small part from the rulings of the ECJ buttressed by secondary legislation in the form of Regulations and Directives. In respect to the provisions for goods, as recognised in Articles 28-37 TFEU[23], the ECJ buttressed their free movement within the European Union (EU) with the introduction of vertical direct effect[24], the eradication of customs duties and charges having an equivalent

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[12] P Craig, 'The Evolution of the Single Market' in C Barnard & J Scott (eds) *The Law of the Single European Market* (Hart, Oxford, 2002) 2
[13] S Weatherill, 'Why Harmonise?' in T Tridimas and P Nebbia (eds.) *European Law for the Twenty First Century* (Hart, Oxford, 2004) 13
[14] See n 3 above
[15] http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2007:306:SOM:EN:HTML 'Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, signed at Lisbon, 13 December 2007' (accessed 25-07-2010)
[16] See n 3 above Articles 2 & 3
[17] G Thorn, 'European Union or Decline: To be or not to be' (1984) Office for Official Publications of the European Communities
[18] Case 26/62 *Van Gend en Loos* v *Nederlandse Administratie Der Belastingen* [1963] ECR 1
[19] Case 6/64 *Flaminio Costa* v *E.N.E.L.* [1964] ECR 585
[20] Case 43/75 *Gabrielle Defrenne* v *Société anonyme belge de navigation aérienne Sabena* [1976] ECR 455
[21] Cases C-6 &9/90 *Francovich and Boniface* v *Italy* [1991] ECR I-5357
[22] M Poiares Maduro, *We, the Court*, (Hart, Oxford, 1998) 7
[23] See n 15 above
[24] See n 18 above

effect[25], the removal of quantitative restrictions and those measures having an equivalent effect and the qualification of the case law concerning the free movement of goods.[26] In respect to the provisions for labour[27], first came clarification of the term[28], their rights including those of job-seekers[29], the underpinning of the principle of non-discrimination on the grounds of nationality[30], and the notion of citizenship of the EU.[31] This emancipation of the freedoms from the confines of text into tangible rights extended also to freedom to provide services[32] with seminal rulings such as *Van Binsbergen*[33] which delivered direct effect for Article 56 TFEU, *Luisi and Carbone*[34] which provided for the freedom to receive services, and *Rush Portuguesa*[35] which assured the right to provide services by a companies' workforce. These rulings were reinforced through the introduction of the Services Directive[36] which, while controversial[37], delivered gains in areas such as administrative simplification and cooperation, authorisation procedures, introduced 'points of single contact' and quality of services.[38]

In stark contrast the final freedom to be addressed within the EU was that of capital. It is clear that the primary objectives of the Treaty were to establish a common market, to approximate

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[25] See Case 24/68 *Commission* v *Italy* [1969] ECR 193 paras.17-18; Case 39/73 *Rewe-Zentralfinanz* v *Direktor der Landwirtschaftskammer Westfalen-Lippe* [1973] ECR 1039 paras.5-6; and Case 314/82 *Commission* v *Belgium* [1984] ECR 1543

[26] See Case 2/73 *Geddo* v *Ente Nationale Risi* [1973] ECR 865; Case 8/74 *Procureur du Roi* v *Dassonville* [1974] ECR 837; Case 128/78 Rewe *Zentrale* v *Bundesmonopolverwaltung für Branntwein* [1979] ECR 649; Case 34/79 *Regina* v *Maurice Donald Henn and John Frederick Ernest Darby* [1972] ECR 3795 ; and Joined Cases C-267 & 268/91 *Criminal proceedings against Bernard Keck and Daniel Mithouard* [1993] ECR I-6097

[27] Articles 45-48 TFEU

[28] See Case 75/63 *Mrs M.K.H. Hoekstra (née Unger)* v *Bestuur der Bedrijfsvereniging voor Detailhandel en Ambachten* [1964] ECR 1977 paras.1-2 ; Case 53/81 *D.M. Levin* v *Staatssecretaris van Justitie* [1982] ECR 1035 paras.12-17; & Case 196/87 *Udo Steymann* v *Staatssecretaris van Justitie* [1988] ECR 6159 paras.11-12

[29] See Case 36/74 *Walrave and Koch* v *Association Union Cycliste Internationale* [1974] ECR 1405 paras.16-18,21; Case C-357/89 *V. J. M. Raulin* v *Minister van Onderwijs en Wetenschappen* [1992] ECR I-1027 paras.14-15; Case C-292/89 *The Queen* v *Immigration Appeal Tribunal, ex parte Gustaff Desiderius Antonissen* [1991] ECR I-745 para.13; Case C-415/93 *Union royale belge des sociétés de football association ASBL and others* v *Jean-Marc Bosman* [1995] ECR I-4921 paras.103 & 131-137; Case C-413/01 *Franca Ninni-Orasche* v *Bundesminister für Wissenschaft, Verkehr und Kunst* [2003] ECR I-13187 paras.28-31

[30] See Case C-209/03 *The Queen, on the application of Dany Bidar* v *London Borough of Ealing and Secretary of State for Education and Skills* [2005] ECR I-2119

[31] Directive 2004/38/EC of the European Parliament and of the Council of 29 April 2004 on the right of citizens of the Union and their family members to move and reside freely within the territory of the Member States

[32] Articles 56-62 TFEU

[33] Case 33/74 *Johannes Henricus Maria van Binsbergen* v *Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid* [1974] ECR 1299

[34] Joined Cases 286/82 & 26/83 *Graziana Luisi and Giuseppe Carbone* v *Ministero del Tesoro* [1984] ECR 377

[35] Case C-113/89 *Rush Portuguesa Ld^a* v *Office national d'immigration* [1990] ECR I-1417

[36] Directive 2006/123/EC of the European Parliament and of the Council of 12 December 2006 on services in the internal market

[37] See n 4 above 400-406

[38] P Craig & G De Búrca, *EU Law: Text, Cases, and Materials* (4th ed., Oxford University Press, Oxford 2008) 844

the economic policies of the MS and to promote the harmonious development of economic activities throughout the Community.[39] However until relatively recently, the free movement of capital within the European Union (EU) was the laggard freedom[40] with a common recognition that, notwithstanding the advances made in regards to the other freedoms, a common market in goods, services and persons can only function efficiently if there is freedom to move the capital associated with such economic activities.[41] Despite in theory the full liberalisation of capital[42] by Directive in 1988, despite the creation of the European Monetary System (EMS) with the express objective of closer monetary cooperation between the MS[43] and European Monetary Union (EMU), and despite the attempts of the ECJ through rulings such as *Sanz De Lera*[44], *Bordessa*[45], and *Trummer and Mayer*[46], the EU continued to struggle to emancipate capital movement and engender a truly European capital market. By 1998 it was clear that even though financial services represented about 6% of the EU GDP[47] and that efficient transparent financial markets help to optimise the allocation of capital by facilitating access to equity financing and risk capital[48], trade continued to be hindered by regulatory and tax barriers[49] at an operational level within and between the MS; most recently exemplified by *Kerckhaert and Morres*[50]; due to the closeness in proximity of capital to fiscal[51], monetary[52] and national sovereignty.[53] In this regard both the Commission and the MS had discovered that the often centuries old evolution of product, profession, service and business standards differed greatly between the MS and that a plethora of vested interests within each Member State (i.e. politicians, lobbyists, Non-Governmental Organisations (NGOs), standards committees, official regulatory bodies and previously developed legislation) had the result of both directly and

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[39] See n 38 above 6
[40] S Peers, 'Free Movement of Capital: Learning Lessons or Slipping on Spilt Milk' in C Barnard & J Scott (eds) *The Law of the Single European Market* (Hart, Oxford, 2002) 333
[41] S Mohamed, *European Community Law on the Free Movement of Capital and the EMU* (Norstedts Juridik AB, Stockholm, 1999) 1-3
[42] Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty
[43] H Ungerer, O Evans & P Nyberg, *The European Monetary System: The Experience*, 1979-82 (Occasional Paper 19, IMF, Washington, 1983)
[44] Joined Cases C-163, 165 & 250/94 *Criminal proceedings against Lucas Emilio Sanz de Lera, Raimundo Díaz Jiménez and Figen Kapanoglu* [1995] ECR I-4821
[45] Case C-416/93 *Criminal proceedings against Aldo Bordessa and Vicente Marí Mellado and Concepción Barbero Maestre* [1995] ECR I-361
[46] Case C-222/97 *Manfred Trummer and Peter Mayer* [1999] ECR I-1661
[47] COM(1998) 625 final 1a
[48] Ibid 1a
[49] P Genschel, 'Why no mutual recognition of VAT? Regulation, taxation and the integration of the EU's internal market for goods', (2007) 14 Journal of European Public Policy 743
[50] Case C-513/04 *Mark Kerckhaert and Bernadette Morres* v *Belgian State* [2006]
[51] M Gregory & D Weiserbs, 'Changing Objectives in National Policy Making' in J Forder & A Menon, *The European Union and National Macroeconomic Policy* (Routledge, London, 1998) 45-46
[52] J Goodman, *Monetary Sovereignty The Politics of Central Banking in Western Europe* (Cornell University Press, New York, 1992) 14-19
[53] http://www.sovereignty.org.uk/features/eucon/fcosov.html Sovereignty and the European Communities, Foreign and Commonwealth Office 30/1048 1971 (accessed 31-07-2010)

indirectly hindering significantly the attainment of the Treaty objectives, particularly in relation to capital. The Commission's response was to connect with those vested interests; exemplified by the Financial Services Action Plan (FSAP)[54] and the Lamfalussy[55] process; to engage this body of Member State operational knowledge as contributory factors for the development of EU legislative proposals.

Given this sprawling backdrop, the recent global financial crisis; whose ramifications continue to impact global trade and investment[56]; and the resultant declared EU solution[57], it is important to focus the specific context for this paper around the regulation and supervision of the economic actors by those vested interests within the MS, specifically the regulation of financial intermediaries (banks, mutual funds, insurance companies, finance companies, securities firms, and pension funds) whose activities provide the link between creditors and borrowers and affect the quantity of money, the investment and ultimately the economic growth of countries.[58] Specifically this paper seeks; firstly, to examine in detail the importance of capital within the global economy and identify the global regulatory framework within which the proposed EU bodies would need to fit; secondly, to briefly outline the more recent European approaches to financial regulation, its journey through harmonisation, mutual recognition, the FSAP[59], the Lamfalussy[60] process, to an inspection of today's proposed 'paradigm shift' by the Commission in favour of centralised EU regulation[61]; thirdly, to identify the operative mechanisms for controlling and managing the risks, positioning them against legal principles such as certainty and coherency, inspecting structures, their linkages and synergies with monetary, competition and social policy; and finally to utilize a hypothesis

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[54] COM(1999) 232 final, 'Financial Services: Implementing the framework for financial markets: Action Plan'

[55] http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf 'Lamfalussy Report 2001' (accessed 16-11-2009)

[56] The Financial Crisis Reform and Exit Strategies (OECD Publications, 2009) 15-23

[57] See http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf COM(2009) 252 final (accessed 12-09-2010);
http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_499_en.pdf COM(2009) 499 final (accessed 12-09-2010);
http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_500_en.pdf COM(2009) 500 final (accessed 12-09-2010);
http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_501_en.pdf COM(2009) 501 final (accessed 12-09-2010);
http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_502_en.pdf COM(2009) 502 final (accessed 12-09-2010); and
http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_503_en.pdf COM(2009) 503 final (accessed 12-09-2010);

[58] M Dewatripont & J Tirole, *The Prudential Regulation of Banks*, (2nd Edn, MIT Press, Massachusetts, 1999) 1

[59] See n 54 above

[60] See n 55 above

[61] COM(2009) 252 final, 'European Financial Supervision'

based approach to analyse the Commission's proposals seeking to enable supportable conclusions to be drawn to key questions concerning; first, whether centralisation provides enhancement to legal certainty and coherency for financial actors; second, whether the *anschluss* or annexation of powers to the proposed new supranational entities is even legal or constitutes an *ultra vires* act which circumvents the principle of conferred powers[62]; and third, whether the close proximity of the resultant formulation, of centralised EU systemic and prudential regulation, to MS sovereignty will negate any expectation of ratification of the proposals given the MS's *raison d'être* remains the promotion of the "economic and social progress for their peoples". [63]

[62] D Chalmers, C Hadjiemmanuil, G Monti & A Tomkins, *European Union Law* (Cambridge University Press, Cambridge, 2007) 211-219

[63] See n 15 above

2. From Capital to Financial Regulation

While it is arguable that "the love of money is the root of all evil[64]" there is little doubt that the risks to a society from ill-formed economic policies are grave. Economic policy stems from common socio-economic objectives such as:

- Full employment of domestic resources perhaps stemming from the unanimous adoption of the 1948 Universal Declaration of Human Rights[65] for many years the primary driver of national macro-economic policy was that of full employment, the classical socio-economic rationale being that full employment provides for participation in the market economy, access to social networks, reduced societal susceptibility to social pathologies such as: family breakdown, alcohol and substance abuse, and deteriorating mental and physical health;[66]
- a low rate of inflation even though a consensus in relation to optimal inflation levels is elusive, conventional macro-economic wisdom highlights interdependencies between inflation, monetary policy and the business cycle predominantly around factors such as: inflation rate (a measure of the rate at which the prices for goods and services is rising), output gap (the difference between actual output and the level of economic activity that the economy can sustain, given its current productive capacity - excluding inflationary pressures), interest rates (dictate the profit over time from an investment) and exchange rates[67], the net result of high inflation on any real economy being acknowledged as negative, in particular delivering declines in outputs, private consumption, investments, and real wages, though conversely an improvement in the balance of trade;[68]
- a reasonable rate of growth and an equitable distribution of income given that the clear conclusion is that growth can lead to substantial reductions in poverty rates[69], but that economic growth in isolation of an equitable re-distribution of wealth would theoretically lead to a substantial increase in income inequality with mean income

[64] *The Holy Bible* (King James Version) Timothy 6:10
[65] http://www.udhr.org/UDHR/default.htm Article 23 (accessed 01-08-2010)
[66] W Mitchell & J Muysken, *Full Employment Abandoned* (Edward Elgar, Cheltenham, 2008) 21
[67] L de Mello & D Moccero, 'Monetary policy and macroeconomic stability in Latin America: The cases of Brazil, Chile, Columbia and Mexico' in L de Mello (Editor) *Monetary Policies and Inflation Targeting in Emerging Economies* (OECD, 2008) 17
[68] http://www.imf.org/external/pubs/ft/wp/2000/wp00085.pdf IMF Working Paper, 'Real Effects of High Inflation' (accessed 01-08-2010)
[69] W Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* (MIT Press, Cambridge, 2001) Chapter 1

distribution[70] increasing in conjunction with the fraction of the distribution below the specified poverty threshold increasing also;[71] and

- more recently, control over environmental pollution.[72]

This symbiosis of economic factors was well understood by the original Treaty authors with the resultant text imbued with the liberalisation of those economic factors necessary to achieve the establishment of a common market and the progressive approximation of the economic policies of the MS.[73] This textual liberalisation, given added stimulus through the activism of the ECJ, exhibiting characteristics such as; primacy over national law, the creation of individual rights, and institutionalised decision-making and judicial review procedures operating as part of MS law; leading to the view that the Treaty is now an economic constitution.[74]

Perhaps the foregoing paragraphs provide some explanation of the rationale for the ill-bounded and contingent nature of the original Article 67 of the Treaty of Rome[75] which led to the slow pace of capital liberalisation even following completion of the transition period, best exemplified by the ECJ's declaration in *Casati*[76] that while the free movement of capital constitutes one of the fundamental freedoms of the Community, it is closely connected to the economic and monetary policy of the MS[77], and that complete freedom of the movement of capital may undermine the economics policy of one of the MS or create an imbalance in its balance of payments and impairing the common market.[78] This close proximity of capital to sovereignty and subsidiarity considerations is demonstrated by the diversity of economic policies to preserve their monetary policy autonomy (the economic strategy chosen by a Member State government in deciding expansion or contraction of the money-supply through the direction of domestic monetary policy objectives towards reducing exchange rate pressures, reducing capital outflows, reducing the inflationary consequences of large inflows,

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[70] National income divided among groups of individuals, households, social classes, or factors of production, to compute an average for comparison purposes.
[71] R Barro & X Sala-i-Martin, *Economic Growth* (2nd Edn., MIT Press, Massachusetts, 2003) 10
[72] D Salvatore, 'National Economic Policies: An Overview' in D Salvatore, *National Economic Policies* (Greenwood Publishing Group, 1991) 3
[73] See n 62 above 513
[74] M Cremona, 'Flexible Models: External Policy and the European Economic Constitution' in G De Búrca & J Scott, *Contitutional Change in the EU* (Hart Publishing, Oxford, 2000) 92
[75] See n 3 above
[76] Case 203/80 *Criminal proceedings against Guerrino Casati* [1981] ECR 2595
[77] Ibid para.8
[78] Ibid para.9

and reducing the exposure to un-hedged foreign currency positions[79], and cheap government financing[80]), innumerable regulatory structures, and the differing financial regulations in use across the MS, whose restrictions of capital inflows and outflows provide many of the fundamental levers for monetary policy, enabling greater direct control over interest rates, foreign exchange and the availability of credit.[81]

Beyond capital's importance, in terms of economic and monetary policy, is the core issue of taxation where the MS explicitly retain ownership of taxation policy. Article 65(1)(a)&(b) TFEU[82] extend the standard derogations justified on the basis of public policy and public security, putting in place the proviso that Article 63 TFEU[83] is without prejudice to the MS' right to apply the relevant provisions of their tax law, or to take all requisite measures to prevent infringements of national law and regulations in the field of prudential supervision of financial institutions. This extension is itself subject to limitation based on Article 65(3) TFEU[84] which provides that the derogations shall not constitute a means of arbitrary discrimination or a disguised restriction to the free movement of capital. In addition Article 223 TFEU[85] provides that all rules relating to taxation of MS shall require unanimity within the Council. Containment to the breadth of these derogations has been achieved, for instance in *Casati*[86] the ECJ declared that administrative measures or penalties must not go beyond what is strictly necessary, the control measures must not be conceived in such a way as to restrict the freedom required by the Treaty and they must not be accompanied by a penalty which is so disproportionate to the gravity of the infringement that it becomes an obstacle to the exercise of that freedom[87]. This was further bolstered in the *Church of Scientology*[88], *Schumacker*[89], *Verkooijen*[90], and *Commission v Portugal*[91], where the limitations of the derogations were clarified. Even direct taxation; which is expressly a retained competency of the MS; is not exempt from EU law given the powers retained by the MS must be exercised consistently with

[79] A hedge is a strategy for reducing the risk of adverse price movements, in this instance Member States' Central Banks could take an off-setting position in relation to any adverse movements of their national currency.
[80] http://www.imf.org/external/pubs/ft/op/op190/pdf/part1.pdf Capital Controls: Country Experiences with Their Use and Liberalisation, IMF 2000, 1 (accessed 01-08-2010)
[81] M Andenas, 'Who is Going to Supervise Europe's Financial Markets' in M Andenas & Y Avgerinos (eds) *Financial Markets in Europe: Towards a Single Regulator?* (Aspen, New York, 2003) Xvii
[82] See n 15 above
[83] See n 15 above
[84] See n 15 above
[85] See n 15 above
[86] See n 76 above
[87] See n 76 above para.27
[88] Case C-54/99 *Association Eglise de scientologie de Paris and Scientology International Reserves Trust v The Prime Minister* [2000] ECR I-1335 paras.17-18
[89] Case C-279/93 *Finanzamt Köln-Altstadt v Roland Schumacker* [1995] ECR I-225 para.24
[90] Case C-35/98 *Staatssecretaris van Financiën v B.G.M. Verkooijen* [2000] ECR I-4071 para.42
[91] Case C-367/98 *Commission v Portuguese Republic* [2002] ECR I-4731 para.52

EU law[92] and that any tax legislation making a distinction between taxpayers on the listed grounds of Article 65 TFEU was not automatically compatible with the Treaty but would be interpreted strictly by the ECJ.[93]

Beyond the endogenous considerations of the EU, each Member State is also subject to Foreign and Direct Investment (FDI) of capital on the global stage due to the neoclassical growth model assertion that the higher marginal product of capital (the the additional output resulting from the application of an additional unit of capital) in poor countries should induce capital to flow into those poorer countries.[94] Notwithstanding the passionate debates between economists and policymakers concerning the virtues of global capital and FDI[95], and the Lucas paradox[96], the importance of capital is aptly highlighted by the increasing scale of capital movement and financial market activities on a global basis which have doubled in the last ten years[97], making FDI the fastest growing form of international capital flows and the most important form of private international financing.[98] While the power of market forces and entrepreneurial business dynamism to generate rising levels of prosperity and productivity is widely acknowledged[99], at a micro-economic level companies are able to transcend borders creating globally integrated production structures, the impact being that globalisation transforms a nation-state into a neo-liberal state which performs three essential services for businesses, namely; adoption of fiscal and monetary policies to assure macro-economic stability, provision of the basic infrastructure necessary for economic activities and finally providing a social order and stability by direct coercion and ideological means.[100] If this is the case then it places an extra pressure on MS' who put in place the monetary linchpin leading to appropriate strategies for liberalising foreign trade and rationalising domestic tax and

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92 Case C-246/89 *Commission v United Kingdom of Great Britain and Northern Ireland* [1991] ECR I-4585 para.12

93 Seen 4 above 548

94 C Kant, 'Foreign Direct Investment and Capital Flight' (1996) 80 Princeton Studies in International Finance 5

95 http://www.iie.com/publications/papers/subramanian0407.pdf 'Foreign Capital and Economic Growth' (accessed 08-08-2010)

96 The paradox created between the theoretical benefits of higher marginal product of capital when investing in poorer countries and the empirical reality of a lack of capital flows from rich to poor countries - see R Lucas, 'Why Doesn't Capital Flow from Rich to Poor Countries?' (1990) 80 American Economic Review 92-96

97 H Davies & D Green, *Global Financial Regulation*, (Polity Press, 2008) 3

98 R Albuquerque et al, 'World market integration through the lens of foreign direct investors' (2005) 66 Journal of International Economics 268

99 http://www.bis.gov.uk/files/file32297.pdf , 'International Trade and Investment – the Economic Rationale for Government Support' (2006) (accessed 08-Aug-2010)

100 J Fichtner, *Does globalisation represent a triumph of the 'Lockean Heartland'?* (GRIN Verlag, Norderstedt, 2004) 14

expenditure policy[101], which by virtue of their EU membership could be argued creates an *erga omnes* liberalisation of FDI across the EU.[102]

These broad considerations concerning domestic capital movements and FDI provided the basis for asserting that the financial markets through which capital movements are facilitated require financial regulation. Llewellyn points out that the objectives of financial regulation need to be clearly defined and circumscribed and include; systemic stability, maintaining the safety and soundness of financial institutions, and consumer protection.[103] Yet disagreement remains with enthusiasts of regulation favour the State's intrusion into economic life because they doubt that the market is capable of performing its self-corrective function and sceptics pointing out that the picture of market failure that the enthusiasts of regulation set forth is misleading and unreliable[104]. There is little doubt that the systemic risk (the risk to the system as a whole that the default of one institution can spread to undermine other institutions[105]) implications, exemplified by Herstatt[106] led directly to the creation of a plethora of international financial regulatory bodies with varying degrees of both authority and success. In particular;

- The, as yet unsuccessful, search for a set of globally agreed accounting and corporate reporting standards through the work of the International Accounting Standards Board (IASB) whose mission remains unfulfilled with the affirmation in 2005 that a common set of high quality global standards remains a long-term strategic priority of both the US's Financial Accounting Standards Board and the IASB[107];
- the attempts to create an international set of standards for auditors through the International Forum of Independent Audit Regulators (IFIAR) which despite inception in 2006 has yet to issue a major report[108];
- the Financial Action Task Force (FATF), a creation of the 1989 G7 summit, whose work on money laundering techniques and trends has resulted in significant operational

[101] R McKinnon, *Money & Capital in Economic Development*, (The Brookings Institution, Massachusetts, 1973) 3
[102] F L Fraga, 'Steffen Hindelang. The Free Movement of Capital and Foreign Direct Investment. The Scope of Protection in EU Law' (2010) 21 (2) EJIL 497
[103] D Llewellyn, 'The economic rationale for financial regulation' (1999) Occasional Paper 1, Financial Services Authority 9
[104] A Georgosouli, 'The debate over the economic rationale for investor protection regulation: a critical appraisal' (2007) 15(3) Journal of Financial Regulation and Compliance (2007) 236
[105] R Cranston, *Principles of Banking* (2nd Ed., Oxford University Press, Oxford, 2002) 66-67
[106] http://www.bis.org/publ/bcbs_wp13.pdf?noframes=1 (accessed 08-08-2010) 4
[107] http://www.iasb.org/NR/rdonlyres/874B63FB-56DB-4B78-B7AF-49BBA18C98D9/0/MoU.pdf (accessed 08-08-2010)
[108] http://www.ifiar.org/reports/index.cfm (accessed 08-08-2010)

level implementations across the 33 members in areas such as: customer identification, ongoing monitoring of accounts and transactions, record keeping and reporting of suspicious transactions, internal controls and audit, and cooperation between supervisors[109];

- the mixed successes of the International Organisation of Securities Commissions (IOSCO) whose objectives, while soft law based, have to some degree been achieved (adoption of IOSCO Objectives and Principles of Securities Regulation, Multilateral Memorandum of Understanding, regulatory cooperation[110]) but whose vast diversity of membership coupled with the short tenure of securities regulators chairs has made it difficult to achieve consensus on many matters[111]; and
- latterly the Basel Committee on banking supervision which was established in the aftermath of Herstatt[112] with the goal of improving supervisory understanding and the quality of banking supervision worldwide[113], who since the implementation of Basel II (a framework setting forth the minimum capital requirements for internationally active banks[114]) is arguably the most successful of the international regulatory bodies with the EU in particular transposing their recommendations vis-à-vis capital adequacy directly into EU Directives.[115]

Despite of the existence of these illustrious international financial institutions and their proactive role in instigating financial regulation, out of the blue their world was shaken to its foundations by the Asian financial crisis of 1997-98. Initiated by a six-fold increase in inbound FDI, reinforced by misguided macro-economic policies, spurred by weak poorly supervised financial sectors, incentivised towards excessive risk-taking, enhanced through inadequate regulatory control coupled with insufficient market transparency, creating an environment

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[109] See n 97 above 57

[110] http://www.fep.up.pt/docentes/ftsantos/interven%C3%A7%C3%B5es/Madrid_IOSCO_OpeningRemarks.pdf 'The Role of IOSCO' (accessed 09-08-2010)

[111] See n 97 above 61

[112] See n 97 above

[113] D Tarullo, *Banking on Basel* (Peter G Peterson Institute for International Economics, Washington, 2008) 2-3

[114] See n 97 above 32-48

[115] Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions OJ L141/1, Directive 98/31/EC of the European Parliament and of the Council of 22 June 1998 amending Council Directive 93/6/EEC on the capital adequacy of investment firms and credit OJ L204/13, and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) L177/201 institutions

that was highly susceptible to liquidity (the ease at which an asset can be bought or sold without affecting its price) and interest rate shocks[116], resulting in a cascade of bankruptcies.[117]

Irrespective of finger-pointing, two positive outcomes in the area of international banking and financial market control emerged in the aftermath; the first was the realisation by the IMF and the World Bank that financial regulation, hitherto unseen as a core component of their activities, would become key; and secondly, the creation of the Financial Stability Forum (FSF), a composite political, central bank, supervisory and policy development organisation[118], now the Financial Stability Board (FSB) whose multi-faceted mandate specifically includes monitoring and advising on market developments and their implications for regulatory policy, and advising on and monitoring best practice in meeting regulatory standards.[119]

Given the foregoing endogenous and exogenous factors one could be forgiven for exclaiming as to how the most recent, and far more serious[120], financial collapse took place. The dramatic events which unfolded during 2007-2008 led to the destabilisation of the global financial markets were predicated, in part, on the basis of the Basel Accords which had incentives built into capital regulations and tax rates which led to arbitrage opportunities between assets with different capital ratios and the use of off-balance sheet vehicles to minimise regulatory capital[121]; the crisis began when the US subprime[122] bubble burst, leading financial institutions to a sell-off of assets generating a loss of trust and confidence in the financial markets[123] which was further exacerbated by the decision of the Federal Reserve not to save Lehman Brothers[124] (itself a prime example of a too-big-to-fail institution which had emerged as a direct consequence of policy[125]), thus escalating the liquidity collapse in interbank funding[126], leaving governments to step in providing guarantees and recapitalising financial institutions.[127]

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116 P Alba, A Bhattacharya, S Claessens, S Ghosh & L Hernandez, 'The role of macroeconomic and financial sector linkages in East Asia's financial crisis' in P Agénor, M Miller, D Vines & A Weber (Eds) *The Asian Financial Crisis Causes, Contagion and Consequences* (Cambridge University Press, Cambridge, 2000) 9-66

117 http://www.ifg.org/imf_asia.html 'IMF's Role in the Asian Financial Crisis' (accessed 09-08-2010)

118 G A Walker, *International Banking Regulation Law, Policy and Practice* (Kluwer Law, London, 2001) 275

119 http://www.financialstabilityboard.org/about/mandate.htm (accessed 09-08-2010)

120 http://www.imf.org/external/pubs/ft/survey/so/2010/boko71310a.htm (accessed 05-Sep-2010)

121 See n 56 above 15

122 The practice of making loans to borrowers who do not qualify for the best market interest rates due to their deficient credit history.

123 House of Lords, 'The future of EU financial regulation and supervision' (2009) 9

124 http://ec.europa.eu/internal_market/finances/committees/index_en.htm 'De Larosière Report' 10-11, 31 (accessed 13-Nov-2009) 12

125 See n 56 above 16

126 R Barrell et al, 'Financial Crises, Regulation and Growth', (2008), 206 National Institute Economic Review 56

127 See n 123 above 9

From an EU perspective, perhaps the most disappointing outcome was the unilateral responses of the MS, who with the International Monetary Fund (IMF) predicting an aggregate cost of the crisis of $11.9 Trillion[128], reacted using national policy overrides[129] to bolster national self interests above the protection of the EU as a whole. This reaction may explain to some degree the policy change of the Commission whose original rationale for financial regulation, couched between the potential financial benefits in GDP terms from a single financial services market[130] (and latterly a retail financial market[131]) and a public policy concern to protect depositors against the risk of loss, prevent this loss across the system as a whole[132], containing contagion and any general flight to cash[133], has now skewed heavily towards the latter, especially given the clear absence of a common framework for crisis management.[134] Perhaps inspired by Rahm's philosophy of never letting a serious crisis go to waste[135], the policy response of the Commission[136] departs from the previous concurrent competence basis and moves towards a "command and control means for influencing behaviour"[137] with the objective of accelerating the previously aspirational goal of a single coherent corpus of law.[138]

[128] http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/5995810/IMF-puts-total-cost-of-crisis-at-7.1-trillion.html (accessed 09-08-2010)
[129] National bank bailouts: http://www.irishtimes.com/newspaper/frontpage/2008/1025/1224838828964.html http://www.spiegel.de/international/business/0,1518,598207,00.html, http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3190311/Banking-bail-out-France-unveils-360bn-package.html, http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3156699/Financial-crisis-UK-bank-bail-out-The-key-points.html (accessed 16-11-2009)
[130] See n 38 above 609
[131] N Moloney, 'Building a Retail Investment Culture through the Law: The 2004 Markets in Financial instruments Directive', (2005), 6(3) European Business Organisation Law Review 353
[132] See n 105 above 66
[133] Ibid 67
[134] See n 124 above 12
[135] http://www.latimes.com/news/opinion/commentary/la-oe-goldberg10-2009mar10,1,1162545.column (accessed 16-11-2009)
[136] See n 61 above
[137] R Baldwin & M Cave, *Understanding Regulation: Theory Strategy and Practice* (Oxford University Press, Oxford, 1999) 68
[138] COM(2005) 629 final, 'White Paper Financial Services Policy 2005-2010' 8

3. Previous European Regulatory Experiences

Despite the recognition of the need for financial services regulation as early as 1966 in the Segré Report[139], firmly echoed in the Werner Report[140], MS remained reluctant to harmonise the operational rules and regulations concerning the free movement of capital even though liberalisation was forthcoming in Directive 88/361[141] and the direct effect (albeit vertical direct effect as the ECJ had only to address an action against the state[142]) of Article 67 (now Article 63 TFEU[143]) recognised in *Sanz De Lera.*[144] The political and Treaty issues specific to financial services were compounded by a general 'euro-sclerosis'[145] due to the pursuit of full harmonisation which required unanimity in the Council. The EU politocracy recognised the sluggish nature of the harmonisation process (only three Directives and one recommendation throughout the 1970s[146]) and the Commission sought to break free of the unanimity shackles, publishing its seminal White Paper[147] in 1985 which sounded the clarion for the Single European Act (SEA).[148]

The new approach to legislation would adopt mutual recognition and equivalence as the basis for intra-Community trade, enabled by a principle of home county control, whereby the home Member State authorises and supervises the financial institution, drawing inspiration from the body of case law resulting from the ECJ rulings in *Dassonville*[149] and *Cassis de Dijon.*[150] In parallel a re-appraisal of the strategy for financial regulation was underway following the collapse of the Bank of Credit and Commerce International (BCCI) in 1991, since some of the jurisdictions in which BCCI operated promised bank secrecy and, implicitly, a lax regulatory regime, to attract international banking operations[151] - suggestive of a 'race to the bottom'. The Commission

139 http://ec.europa.eu/economy_finance/emu_history/documentation/chapter1/19661130en382develeurocapitm_a.pdf 'The Development of a European Capital Market' (accessed 09-08-2010)

140 http://aei.pitt.edu/1003 (accessed 16-11-2009)

141 Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty

142 See n 81 above Xix

143 See n 15 above

144 Joined Cases C-163, 165 & 250/94 *Criminal proceedings against Lucas Emilio Sanz de Lera, Raimundo Díaz Jiménez and Figen Kapanoglu* [1995] ECR I-4821

145 M Jovanović, *The Economics of European Integration Limits and Prospects* (Edward Elgar Publishing, Massachusetts, 2005) 20-22

146 Directive 77/780/EEC; Directive 79/267/EEC; Directive 79/279/EEC and Recommendation 77/534/EEC

147 COM (85) 310 final 'Completing the Single Market: White Paper from the Commission to the European Council'

148 http://europa.eu/legislation_summaries/institutional_affairs/treaties/treaties_singleact_en.htm (accessed 09-08-2010)

149 Case 8/74 *Procureur du Roi* v *Dassonville* [1974] ECR 837

150 Case 120/78 *Rewe-Zentrale AG* v *Bundesmonopolverwaltung für Branntwein* [1979] ECR 649

151 See n 105 above 106

acted by adopting a new Consolidated Supervision Directive[152] and later the Prudential Supervision Directive.[153] Re-invigorated by the success of the SEA the Commission pressed forward for EMU with the Maastricht Treaty containing the modifications necessary for its attainment.[154]

Achievement of the EU's financial services policy did not automatically succeed from EMU[155] even though the foreign-exchange related barriers were irrevocably removed, financial markets remained segmented and business and consumers continued to be deprived of direct access to cross-border financial institutions. Recognition of the remaining hurdles (modernising the regulatory apparatus, smoothing remaining cross-border fiscal barriers, engendering a retail financial market culture, and removing fault-lines in supervision and regulation[156]) was first addressed through the policy statements and discrete activities of the FSAP[157], which exhorted specific actions to be carried out under the banner of three strategic objectives specifically, wholesale markets, retail markets and state-of-the-art prudential rules and supervision.[158] One of the hallmarks of the FSAP period has been a growing sophistication in the law-making process buoyed by the introduction of the Lamfalussy process[159] itself emergent from the work of the Lamfalussy Committee who were tasked with identifying the remaining impediments to the integration of EU securities markets.[160]

In terms of addressing the multi-country issues inherent in the EU, the Lamfalussy process[161] has done much to address the needs of policy execution. Its original "remit was to assess the current state of integration in the securities and investment services markets and the harmonised structure supporting them".[162] The report identified fragmentation of the EU financial services market, high costs of cross-border transactions, and loss of benefits from

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[152] Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis
[153] European Parliament and Council Directive 95/26/EC of 29 June 1995 amending Directives 77/780/EEC and 89/646/EEC in the field of credit institutions, Directives 73/239/EEC and 92/49/EEC in the field of non- life insurance, Directives 79/267/EEC and 92/96/EEC in the field of life assurance, Directive 93/22/EEC in the field of investment firms and Directive 85/611/EEC in the field of undertakings for collective investment in transferable securities (Ucits), with a view to reinforcing prudential supervision
[154] See n 4 above 556
[155] COM(1998) 625 final, 'Financial Services: Building a Framework for Action' 1
[156] Ibid 2
[157] See n 54 above
[158] Ibid 22-28
[159] http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf 'Lamfalussy Report 2001' (accessed 09-08-2010)
[160] See n 62 above 805
[161] See n 159 above 6
[162] N Moloney, *EC Securities Regulation* (Oxford University Press, Oxford, 2004) 21

lack of integration.[163] The answer proffered by the Lamfalussy Committee was a 'novel' and potentially more rapid and efficient, regulatory process.[164] This revolutionary four-level process was legitimised democratically by introducing open and systematic public consultation, in the form of consultation papers, on which all parties with vested interests … "would have the opportunity to comment within a clearly specified deadline, as well as of an open hearing, where possible[165]" in advance of the Commission initiating the legislative process. The success of the Lamfalussy process is tangible with four "Level 1" Directives being implemented as part of FSAP[166] and the establishment of League Tables to encourage the MS to transpose the Lamfalussy Directives in a timely manner.[167]

The financial services policy agenda was further expanded in the post-FSAP White Paper[168] making clear that the "Better Regulation[169]" policy of the Commission over the next five year period is to: consolidate dynamically towards an integrated, open, inclusive, competitive and economically efficient EU financial market; remove remaining economically significant barriers; implement, enforce and continuously evaluate the existing legislation; and enhance supervisory cooperation and convergence in the EU.[170] As recently as 2005 the approach was to keep faith with and develop the Lamfalussy process specifically in regards to the comitology reform, accountability and transparency, cross-sector regulatory cooperation, and working towards the global convergence of regulatory standards – where practical.[171]

By 2009 however, in the aftermath and recriminations[172] associated with the global financial crisis a 'sea-change' in the approach of the EU politocracy was revealed. The first inklings of a change in approach came with the publishing of the De Larosière report[173], which declared that it be recognised that the implementation and enforcement of financial regulatory

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163 See n 159 above 7-8
164 See n 62 above 806
165 See n 62 above 811
166 Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC
167 http://ec.europa.eu/internal_market/securities/transposition/index_en.htm (accessed 09-08-2010)
168 COM(2005) 629 final, 'White Paper Financial Services Policy 2005-2010'
169 Ibid 5
170 Ibid 4
171 See n 138 above 10
172 http://www.time.com/time/specials/packages/completelist/0,29569,1877351,00.html (accessed 24-08-2010)
173 See n 124 above

standards would only be effective and lasting if the EU had a strong and integrated European system of regulation and supervision.[174] The report draws a clear distinction between regulation and supervision (rule setting as opposed to rule enforcement)[175] and extols the virtues of EU level regulation founded on the basis of at least four reasons, namely; the desire for a single market, removal of competitive distortions, efficiency, and cross-border crisis management.[176]

In a similar vein, the Turner Review[177], describes in detail the need for a systemic approach and highlights in stark terms that even though there is an underlying philosophy common in EU regulation, the crisis has shown this philosophy to be inadequate and unsustainable for the future[178], further emphasizing the need to debate the creation of a new independent EU institutional structure to replace the Lamfalussy committees with authoritative regulatory powers.[179]

By March 2009 the Commission had taken up this mantle declaring that "the crisis has exposed unacceptable risks in the current governance of international and European financial markets which have proved real and systemic in times of serious turbulence. The unprecedented measures being taken to restore stability ... must be matched by robust reform to remedy known weaknesses, identify and prevent the emergence of new vulnerabilities in the future".[180] By May of 2009 the Commission had released more specific details of their proposed legislative agenda for a new supervisory framework for the EU.[181]

The view of the Commission is to centralise both the macro and micro regulation and supervision of financial services[182] legally founded on the basis of Article 114 TFEU. In particular, given the emergence of systemically important financial firms[183], their interconnectedness, the resulting contagion risk and the liquidity constraints this drove across the market as a whole[184] the Commission are seeking to create a European Systemic Risk Council (ESRC) to address macro-prudential issues, to analyse complex interconnected risks and to make recommendations in terms of regulatory and supervisory policy.[185] At the micro-prudential

[174] See n 124 above 3
[175] See n 124 above 13
[176] See n 124 above 27
[177] http://www.fsa.gov.uk/pubs/other/turner_review.pdf The Turner Report (accessed 23-08-2010)
[178] See n 177 above 100
[179] See n 177 above 102
[180] COM(2009) 114 final, 'Driving European Recovery' 4
[181] See n 61 above
[182] See n 61 above 3
[183] See n 105 above 66
[184] See n 56 above 16
[185] See n 61 above 4

supervision level the Commission states that it has reached the limits of what can be done with the present Committees [186] (the Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Committee (CEIOPS), and the Committee of European Securities Regulators (CESR)) and is seeking to introduce the European System of Financial Supervisors (ESFS) with defined legal powers and personality to ensure; a single set of harmonised rules, consistent application of EU rules, a common supervisory culture with consistent practices, a coordinated crisis response, collect micro-prudential information, undertake an international role, and to act as the supervisor for specified pan-EU entities.[187]

As highlighted earlier, given the proximity of financial markets to national interests, there is tangible fear that the micro-prudential role of the ESFS would lead to the progressive reduction of some of the traditional prerogatives of MS sovereignty with the risk of favouring trends towards lower levels of protection, efficiency, and essentially the selfish logic of the market.[188] The House of Lords has raised the fact that strengthening EU micro-prudential supervision runs counter to the current Treaty, which limits significantly the power of any such supervisor and is a matter of some controversy.[189] This is echoed by the UK Financial Services Authority (FSA) who reported to the Treasury Committee that there are two diametrically opposed approaches to European cross-border regulation; the first ostensibly being a centralised supervisory model with a shared European fiscal responsibility for rescue if ever required and appropriate, the second being the removal of the passport rights derived from the Second Banking Coordination Directive[190] (2BCD) operative since 1989 leaving host MS free to demand separate subsidiarisation in order to operate within their borders; and that the only certainty is that there is no support for either of these intellectually pure solutions.[191]

Given the comments of the FSA and the polarisation of the intellectually pure options available[192], the Commission's proposed legislative reforms (respectively those concerning macro-prudential[193] and those concerning micro-prudential[194]) were, not unexpectedly, a

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[186] See n 61 above 8
[187] See n 61 above 9-11
[188] G Alpa, 'The Harmonisation of the EC Law of Financial Markets in the perspective of Consumer Protection' (2002) 13(6) European Business Law Review 528
[189] See n 123 above 5
[190] Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC
[191] http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/1088/1088.pdf (accessed 24-08-2010) 7
[192] Ibid
[193] COM(2009) 499 final Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a

compromise between the single market and national fiscal interests.[195] In brief the final legislative proposals provide for the creation of a European Systemic Risk Board (ESRB) with a general board composing the Governors of the national central banks, the President and vice-President of the European Central Bank (ECB), a Member of the Commission, and the Chairpersons of the three European Supervisory Authorities.[196] Critically the ESRB will not have any binding powers over the MS but is conceived as a reputational body to influence policy makers. Instead the ESRB will produce reports, assessments, risk warnings and recommendations.[197]

In contrast the proposals concerning the ESFS revolve around the drive to generate a single supervisory rule book, develop a means for resolving disagreements between national supervisors, to discharge the current tasks associated with the Lamfalussy level 3 Committees, and to discharge international advisory duties on behalf of the EU[198]. In contrast to the ESRB the ESFS will have binding powers, including;

- Drafting proposals for technical standards working towards more consistent rules and a common rulebook;
- facilitating exchanges of information and agreement between MS supervisory authorities;
- settling any disagreements, including within colleges of supervisors, to ensure supervisors take a more coordinated approach;
- contributing towards ensuring the consistent application of Community rules – to ensure incorrect or inconsistent application is dealt with quickly and effectively;
- exercising direct supervisory powers for credit rating agencies; and
- co-ordinating decision-making in emergency situations.[199]

Clearly, from the foregoing, the goal of the EU politocracy continues to be the introduction of EU financial regulation and supervision founded on the potential financial benefits in GDP

European Systemic Risk Board

[194] COM(2009) 576 final Proposal for a Directive of the European Parliament and of the Council Amending Directives 1998/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC, and 2009/65/EC in respect of the powers of the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority

[195] See n 191 above 8

[196] See n 193 above 7

[197] See n 193 above 5

[198] See n 194above 5

[199] MEMO/09/404 European System of Financial Supervisors (ESFS): Frequently Asked Questions http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/404 (accessed 24-08-2010)

terms for the EU from a single market in financial services[200], and an EU public policy concern to protect depositors against loss and to prevent this loss across the system as a whole[201] by containing any contagion and a general flight to cash.[202]

Now however with new impetus, those arguments are under-pinned with crisis concerns[203] and certainty rhetoric which implies that without their implementation a further EU financial collapse would likely materialise. The proposed legislation seeks to address the continued fragmentation that is exhibited in the EU's financial markets[204]; with MS exhibiting diverse regulatory and supervisory cultures, for example, with regards to the role of the state and retained a variety of regulations and supervisory systems with competences remaining at national level with parliaments, banks or other supervisory institutions[205]; and while the notion of legislative proposals concerning EU-wide financial regulation and supervision is welcomed in many quarters[206], the fact remains that a shared rationale is a far-cry from direct guidance as to the techniques by which those objectives are to be given effect, which itself accounts for the differentials of regulatory and supervisory approaches around the world.[207]

[200] See n 38 above 609
[201] See n 105 above 66
[202] Ibid 67
[203] See n 194 above 8-9
[204] http://ec.europa.eu/internal_market/finances/docs/cross-sector/fin-integration/efir_report_2009_en.pdf (accessed 25-08-2010)
[205] http://www.eurodad.org/uploadedFiles/Whats_New/Reports/EUMapping_Financial_Regulation_FINAL.pdf Financial Regulation in the European Union' (accessed 09-08-2010)
[206] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/108622.pdf (accessed 24-08-2010) para.21, see also n 191 above 13-14
[207] I McNeil, *An Introduction to the Law On Financial Investment*, (Hart Publishing, Oregon, 2005) 25

4. Mechanisms for financial regulation & supervision, the missing Lender of Last Resort (LOLR), and the unanswered accountability question

Having examined the importance of capital within the global economy, identified in brief the global regulatory framework, outlined the EU politocracies' experience with financial regulation, and inspected the proposed paradigm shift to centralised EU regulation, this paper turns to the operative components that can be deployed to manage and control the financial risks associated with capital movement and financial investment seeking to reveal at a more granular level how the attributes of the regulatory implementation come to reflect the boundary choices; exemplified through independence from the Executive, adjudicatory functions, investigative rights, prosecution rights, and policy formulation[208]; between the appropriate accommodation of practitioner objectives and regulatory capture, whose constituent influencers can polarise policy[209], undermining certainty and coherency and leading to a breakdown of confidence.

Notwithstanding the fact that the politocracy have proposed that the European Supervisory Authorities (ESAs) should have defined legal powers, greater authority, an objective to establish a single EU rulebook, a goal to eradicate differences in national transpositions, and a target of effectively harmonising EU financial regulation[210], with further powers concerning oversight, investigation and infringement remediation.[211] Perhaps unsurprisingly, perhaps understandably (given its breadth), the politocracy have crafted a set of legislative proposals [212] that engender uncertainty being light in terms of the specific detail[213] concerning any planned operative changes which would necessarily be required to manage and control financial risks.

Across the EU and globally the structural mechanisms for financial regulation and supervision are innumerable, comprising a single mega-regulator, a twin-peak approach of prudential and conduct of business agencies[214], a three-peak model such as that recommended by the Wallis

[208] See n 137 above 69
[209] C Goodhart et al, *Financial Regulation: Why, How and Where Now?* (Routledge, London, 1998) 7
[210] COM(2009) 501 final, Regulation of the European Parliament and of the Council establishing a European Banking Authority 4-5; COM(2009) 502 final, Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority 4-5; and COM(2009) 503 final Regulation of the European Parliament and of the Council establishing a European Securities and Markets Authority 4-5
[211] See n 210 above pages 5-6 respectively
[212] See n 193 above
[213] http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/1088/1088.pdf (accessed 13-09-2010) 25
[214] See n 209 above 157

Report[215] comprising systemic stability, prudential regulation and market integrity coupled with consumer protection[216], or even a four-peak approach comprising macro-stability, supervision, transparency, and anti-trust.[217] This sequential increase could continue with Goodhart suggesting six-peaks enabling differentiation of retail and wholesale considerations.[218]

Irrespective of whether at the top-level there is a single mega-regulator such as the United Kingdom's FSA, or a duality of regulators like the Netherlands through the Dutch Central Bank (DNB) and Authority for Financial Markets (AFM), the underlying foci of regulators is common, those being systemic, prudential and conduct of business risks. Noting these considerations, with the current proposals the Commission have grasped the nettle of isolating a set of core qualities for financial regulation and supervision, in the first instance by disaggregating the systemic risk considerations: the remote possibility of a chain reaction, a cascading sequence of defaults that will culminate in financial implosion if it is allowed to proceed unchecked[219]; from the prudential risk considerations: in its strictest sense the solvency, liquidity, asset riskiness, capital structure, income streams, and incentive schemes[220] of financial institutions or beyond this encompassing the adoption of standards of financial soundness for individual institutions and their enforcement through licensing, continuous supervision and the imposition of sanctions[221]; and consumer protection primarily through conduct of business risk as exemplified in Articles 19, 21 and 22 of MIFID[222], in the second instance by directly addressing the well recognised sectoral or functional differentiations between banking, insurance, securities, pensions and exchanges, through direct separation as embodied by the ESA's respectively the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA).

The final bastion underpinning all regulation and supervision is ultimately the measures taken to restore confidence during a crisis, and it is this specific topic which lies largely unaddressed

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215 http://fsi.treasury.gov.au/content/downloads/FinalReport/overview.pdf 'Wallis Report' (accessed 20-11-2009)
216 See n 215 above
217 G Di Giogio & C Di Noia, 'Financial Regulation and Supervision in the Euro Area: A Four-Peak Proposal' (2001) Wharton Financial Institutions Center 20-21
218 See n 209 above 159
219 See n 209 above 9
220 See n 58 above 5
221 See n 62 above 824
222 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC

in the current legislative proposals.[223] While the proposals encompass additional tasks for the ECB relating to the collection of information on behalf of the ESRB[224], they are bereft of specific proposals concerning an EU-wide lender-of-last-resort (LOLR).

From a sectoral or functional dimension, the proposed ESA's are capable of providing the differentiated means for regulation and supervision focused on the specialist requirements of each type of business. For instance, the underlying basis of banking where deposits are taken and invested in illiquid longer term projects or assets[225], differs dramatically from that of insurance where their liabilities are long term, their assets are readily marketable and there are no linkages between insurance firms through market trading or the payments system[226], and both differ from securities firms whose exposures relate to market risk rather than credit risk[227] and whose conduct requires closer scrutiny in terms of transparency, conflicts of interest, and liquidity.[228]

From a structural perspective regulation and supervision in terms of a discrete focus based on the specialisation of the institution was proposed in the US in 1986 as a response to the growing realisation that the previously monolithic regulation of the Glass-Steagall Act 1929 was being undermined by economic changes, financial product innovation, mergers and acquisition activities, technological advances and regulatory overlaps.[229] The US result was the Gramm-Leach-Bliley Act 1999 providing that banks could be involved in diversified activities such as underwriting securities or brokerage and that these components of the banks activities would be monitored and supervised by the relevant specialist (nee functional) regulator.

The current proposals have obviated concerns that the specialisation of prudential supervision (for instance between banks and insurance companies) would be ineffective with a single agency.[230] At a lower level of disaggregation there is little doubt that regulations would need to differ in relation to compliance policies, organisational and administrative arrangements to prevent conflicts of interest, business continuation, outsourcing and operational risk,

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[223] See n 193 above
[224] COM(2009) 500 final, Proposal for a Council Decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board, Article 5
[225] C Goodhart & G Illing (eds) *Financial Crises, Contagion and the Lender of Last Resort*, (Oxford University Press, Oxford, 2002) 15
[226] See n 209 above 14
[227] See n 209 above 12
[228] N Moloney, 'Financial market regulation in the post-Financial Services Action Plan era', (2006), 55(4) International Comparative Law Quarterly 990
[229] J Shad, 'Functional Regulation – The Concept and its Applications' (1986) http://www.sec.gov/news/speech/1986/052186shad.pdf (accessed 17-10-2009)
[230] See n 225 above 163

accounting procedures, internal control mechanisms, risk assessment procedures and safeguard arrangements for IT systems, evidences and record keeping and ring fencing rules for client funds and assets.[231]

EMU "revolutionised the way in which macro-economic policy is formulated and implemented, especially for those Member States' participating in the eurozone"[232] moving decision-making autonomy for monetary policy to a supranational authority, namely the European System of Central Banks (ESCB). In respect of the key dimension of LOLR services they would be provided, in the case of the EU, by the ECB, further coordinated to non-euro members through the ESCB, and carried out using open market operations (OMO).[233] From Bagehot[234] onwards the core principle of LOLR is that lending is reserved for solvent banks facing liquidity problems.[235] But as we have seen the increasing cross-border externalities (through FDI[236]) coming from the growing number of banking groups with significant cross-border presence represents considerable concern for public policy officials.[237] In crisis situations a national banks' LOLR role is well recognised[238] with liquidity to be provided by engaging in money-market transactions[239], which necessarily has monetary policy implications.

The ability to act in concert throughout the EU continues to be inhibited, in respect of LOLR[240] by the geographic dimension and the retention of monetary policy over-rides by Member State governments in the event of emergency situations, such as that in the UK.[241] However, when a national central bank does not have the capital resources to handle a domestic crisis, it turns to the finance ministry and ultimately to the taxpayer[242] further exemplifying the proximity of capital movements, regulation, supervision and national sovereignty. The unilateral responses and national policy overrides enacted during the recent financial crisis[243] highlight clearly that national governments have no hesitation in reacting to protect their own societies.

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[231] See n 228 above 987
[232] See n 62 above 528
[233] Protocol on the Statute of the European System of Central Banks and of the European Central Bank, Article 18, Open market and credit operations
[234] X Freixas et al, 'Lender of Last Resort: A Review of the Literature' in C Goodhart & G Illing (eds) *Financial Crises, Contagion and the Lender of Last Resort*, (Oxford University Press, Oxford, 2002) 27
[235] C Wihlborg, 'Lender of last resort' in K Reinert & R Rajan (eds) *The Princeton Encyclopedia of the World Economy Volume I* (Princeton University Press, New Jersey, 2009) 732
[236] See n 98 above
[237] http://www.riksbank.com/pagefolders/26594/2006_2artikel2_sv.pdf 'Supervisory arrangements, LoLR and crisis management in a single European banking market' (accessed 05-11-2010)
[238] Ibid 20
[239] See n 355 above 122
[240] See n 234 above 732
[241] See n 225 above 115
[242] See n 241 above 20
[243] See n 129 above

The current lack of fiscal responsibility for the EU politocracy due to subsidiarity considerations[244], exemplified by the soft nature of the multilateral surveillance procedure[245] and the failed attempts of the Commission to reign in France, Ireland, Greece and Spain[246] under the excessive deficit procedure[247], and the philosophy of minimal essential harmonisation, together act as sources of continuing fragmentation and concern[248] - aptly illustrated by the bail-out of Greece by the German government through the EU[249] - leaves an accountability void, which; while the most recent proposals[250] do represent clear action to address financial regulation and supervisory ambiguities, providing succour for the future in respect of legal certainty and the coherency of EU law; has left unanswered (perhaps purposefully for now) the question as to who is accountable to give liquidity assistance in the case of a major bank failure that has systemic consequences at the European level, threatening banks across many borders?[251]

[244] Article 5 TEU
[245] See n 38 above 734
[246] http://ec.europa.eu/economy_finance/articles/sgp/article14582_en.htm (accessed 05-09-2010)
[247] Article 126 TFEU
[248] A Boot & M Marinč, 'Crisis Management and Lender of Last Resort in the European Banking Market' in P Alessandrini, M Fratianni & A Zazzaro (eds) *The Changing Geography of Banking and Finance* (Springer, London, 2009) 234
[249] http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/7199625/Germany-backs-Greek-bail-out-as-EU-creates-economic-government.html (accessed 05-09-2010)
[250] See n 193 above
[251] M Schüler, 'Supervision of the European Banking Market' in H Berger & T Moutos (eds) *Designing the New European Union* (Elsevier, Amsterdam, 2007) 210

5. A broader analysis of the Commission's proposals

Latterly the attention of this paper turns to a broader analysis of the Commission's proposals[252] utilising a hypothesis based approach to segment the analysis.

5.1 Hypothesis #1 – Centralised EU regulation and supervision founded on the basis of clear ideological underpinnings will lead to greater certainty, coherency, and consistency within the European capital market

Ratifying each aspect of the Commission's proposals[253] concerning EU financial regulation and supervision, means discussions concerning which areas of regulation are undertaken primarily at the national level as opposed to those needing international collaboration are obviated.[254] In theory, the significant certainty risks arising from the serious divergences in the parallel national liability and enforcement regimes which persist, given the limited harmonisation in these areas under the FSAP[255], could be quickly overcome.

Indeed, the ESA's could demystify the confusion surrounding the evolution of the concept of the 'general good'[256], the legal uncertainty surrounding its interpretation in terms of the Banking and Financial Service Directives[257], and directly emanating from the ECJ in cases such as *German Insurance*[258], *Alpine Investments*[259], *Svensson*[260], *Ambry*[261] and *Centros*[262], to name but a few. Additionally the ESA's could diffuse any uncertainty originating from the 'third way' harmonisation, namely 'adequate' or 'effective' harmonisation[263], its relationship with the doctrine of *effet utile*[264] and any lingering uncertainty surrounding the areas where harmonisation has reached a 'maximum' character and those where MS are still allowed to impose 'super-equivalent' standards.[265] The counter is that the Lamfalussy Level 3 process

[252] See n 136 above
[253] See n 193 above
[254] See n 345 above 182
[255] See n 162 above 35
[256] M Tison, 'Unravelling the General Good Exception: The Case of Financial Services' in M Andenas & W Roth (eds) *Services and Free Movement in EU Law* (Oxford University Press, Oxford, 2003) 321-381
[257] See n 256 above 321
[258] Case 205/84 *Commission* v *Germany* [1986] ECR 3755 para.28
[259] Case C-384/93 *Alpine Investments BV* v *Minister van Financiën* [1995] ECR I-1141 para.19
[260] Case C-484/93 *Peter Svensson and Lena Gustavsson* v *Ministre du Logement et de l'Urbanisme* [1995] ECR I-3955 para.10
[261] Case C-410/96 *Criminal proceedings against André Ambry* [1998] ECR I-7875 para.39
[262] Case C-212/97 *Centros Ltd* v *Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459 para.27
[263] See n 299 above 449
[264] Ibid
[265] See n 299 above 449

already supports maximum harmonisation, which should lead to greater certainty and convergence.

Perhaps the core issue is that the "barriers related to legal certainty reflect more fundamental differences in the concepts of underlying national laws and would appear more difficult to remove than barriers in the other categories".[266] Whether the ESA's acting with the ESFB can cut more effectively to the certainty wick is questionable given that beyond high level regulation there remains uncertainty at the grass-roots as to the avenues of legal recourse available across borders. For example, the introduction of FIN-NET in 2001 to provide a redress network for financial-services disputes by linking together national out-of-court settlement bodies[267] or the introduction of SOLVIT in 2002 have done little towards realising an EU retail investment market, with reports that "consumers do not appear to distinguish between buying products from domestic or foreign providers, as long as they are established in the local market – only 5% of EU citizens have bought financial products in another Member State".[268] In short, it can be questioned whether the introduction of centralised regulation and supervision can address the serious certainty deterrents for cross-border financial services.

In terms of economies of scale the notion exhorted by proponents of centralised regulation is that the reduction in transaction and compliance costs will drive increased competitiveness for consumers and hence drive forward the EU Internal Financial Market.[269] They point to the advantages from convergence of supervisory powers in the concentration and prioritisation of resource allocation[270] and the benefits that can be gleamed from re-organising and directing the incentive structures.[271] The counter is that the information loss due to process streamlining in an effort to drive efficiency would negate the benefits being sought, and the high staff turnover exhibited in concentrated regulatory authorities.[272] In respect of culture the main question would be the type of culture one wishes to create and the chosen strategies[273] to be followed, namely red lights or green lights.[274] The dangers from a cultural perspective are encapsulated within the risks of ill-designed regulation, that of investor paralysis due to the

[266] http://ec.europa.eu/internal_market/financial-markets/clearing/communication_en.htm#ecofin (accessed 06-11-2009) 'First Giovannini Report'
[267] N Moloney, 'Effective Policy Design for the Retail Investment Services Market: Challenges and Choices Post FSAP' in G Ferrarini and E Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, The MiFID and Beyond* (Oxford University Press, Oxford, 2006) 426
[268] Ibid 424
[269] See n 354 above 354
[270] CESR, 'The Role of CESR at "Level 3" under the Lamfalussy Process', (2004) CESR/04-527b
[271] See n 319 above 493
[272] See n 319 above 505
[273] See n 345 above 4-5
[274] See n 137 above 68

power concentration and regulatory egress because of "regulatory empire-building"[275]and by the need to maintain a "careful balance between appropriate accommodation of practitioner objectives on the one side, and regulatory capture"[276] on the other.

Lastly, the issue of accountability comes to the fore. The accountability of national financial regulators is ultimately to their public through political bodies. If the ESA's political and legal accountability mechanisms had followed the blueprints laid forth for the ECB, given their recent creation; which is accused of being uniquely feeble[277]; they would have likely been unsuccessful. However, the politocracy have chosen a mechanism more akin to the European Competition Network (ECN) which leverages the in-situ accountability mechanisms of the national regulators. Problems with this approach are extant, for instance the legal accountability of the UK's FSA is questionable given that the UK Courts' have held that no duty of care exists[278], yet their political accountability to Parliament is clear. A similar system operates in Germany through the Federal Financial Supervisory Authority (BaFin) being accountable to the German Minister of Finance. The difficulty for EU accountability lies in the accountability of the EU institutions themselves, given the ongoing questions vis-a-vis their own democratic deficit.[279] Alternatively, accountability to the European Parliament would solve the legitimacy issue but presents an issue in terms of authority with the European Parliament lacking any direct monetary or fiscal policy authority.

In summary, it is unclear whether the recent proposals[280] are founded and motivated by a specific ideology, such as federalism or inter-governmentalism and the speed of their drafting raises questions as to the soundness of ideological anchor and ethos underpinning their necessity. Nevertheless, the have taken account of the past experience, notably that of the creation of the ECN which exemplifies a regulatory "network in which all members apply the same law and policy … throughout the single market".[281] As we have seen, the now ratified the proposals can potentially deliver reduced certainty risks, drive convergence and enhance an EU-wide culture in financial services, with the caveat that democratic accountability has yet to be directly addressed.

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[275] See n 267 above 412
[276] See n 345 above 7
[277] See n 311 above 547
[278] See n 308 above 87-88
[279] http://europa.eu/scadplus/glossary/democratic_deficit_en.htm (accessed 05-09-2010)
[280] See n 193 above
[281] COM (2000) 582 Final 'Proposal for a Council Regulation on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty and amending Regulations (EEC) No 1017/68, (EEC) No 2988/74, (EEC) No 4056/86 and (EEC) No 3975/87 OJ2000 C365E/284

5.2 Hypothesis #2 – The annexation of financial regulation and supervision to the EU constitutes an *ultra vires* action by the Commission and a circumvention of their conferred powers

There is no competence in the Treaty of Rome or its successors which provides directly for the creation of additional supra-national institutions other than those provisioned within the Treaty itself in Article 13 TEU.[282] The principle of conferred powers[283], in theory, ensures that contrary to the MS, having inherent possession of plenary powers[284], the Community only enjoys those powers that are conferred upon it for the achievement of its specific objectives. The position is more complex though with the reference to 'objectives', the definition alludes to some implied powers[285], which can be taken to mean that the "founding States preferred that the system adopted should contain an indispensable flexibility, which could be best obtained via a functional attribution".[286] This was the position asserted by the European Court of Justice (ECJ) in *Commission* v *Germany*[287] where it held that "it must be emphasized that where an Article of the EEC Treaty … confers a specific task on the Commission it must be accepted, if that provision is not to be rendered wholly ineffective, that it confers on the Commission necessarily and *per se* the powers which are indispensable in order to carry out that task".[288]

The introduction of subsidiarity in Maastricht[289] providing that in "areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity"[290] means that the EU may only create a set of new regulatory agencies if the necessary powers for the intended action have been transferred by MS to the Community.[291] This regard to subsidiarity is exemplified by the careful construction of the European Central Bank (ECB) whose creation and competencies were carefully crafted (specifically not inclusive of insurance thereby obviating their ability to become an EU financial regulator[292]) centralising only those functions essential for the execution of joint monetary policy and the realisation (at that time) that bank supervision can be better executed at the

[282] See n 15 above
[283] Article 5 TEU
[284] See n 7 above 58
[285] Y Avgerinos, 'EU Financial Market Supervision Revisited: The European Securities Regulator' (2003) New York University School of Law 11
[286] See n 284 above 58
[287] Joined Cases 281, 283-285 & 287/85 *Federal Republic of Germany and others* v *Commission* [1987] ECR 3203
[288] Ibid para.28
[289] http://eur-lex.europa.eu/en/treaties/dat/11992M/htm/11992M.html (accessed 06-11-2009)
[290] Article 5 EC
[291] See n 285 above 11
[292] See n 62 above 824

local level.[293] "Therefore (and consistently with the principle of subsidiarity) the focus [had] been on determining the respective roles of the EU law-making institutions on the one hand and the Member State on the other".[294]

Undeterred by subsidiarity considerations, the politocracy have sought the centralisation of financial regulation for many years, evident in both word and deed; in words from the criticism, pre-FSAP, of the context of multiplicity of national regulation and regulatory diversity which inhibited the formation of an Internal Financial Market[295], through the FSAP actions with respect to wholesale markets, retail markets, and sound supervisory structures[296], and reiterated more strongly post-FSAP under the banner of Better Regulation[297]; and in deeds, the generational differentiation between legislation such as those of the early 1980s i.e. the Second Banking Coordination Directive[298] (founded on minimum harmonisation[299]) through the MiFID Directive[300] (founded on maximum harmonisation[301]).

The distinct departure from a concurrent competence basis as encompassed in the most recent COM(2009) proposals[302] may take their inspiration from the Rahm philosophy of never letting a serious crisis go to waste.[303] From a legal perspective these recent proposals may be viewed in the same light as that of the titanium oxide judgment[304] where "the ECJ held that the concept of the Internal Market … has to be interpreted very widely"[305], or that of the German challenge to the Deposit Guarantee Directive[306] where their objection to the Directive was examined in the light of both subsidiarity and proportionality.[307] Germany argued that

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[293] K Lanoo, 'Financial Supervision and Economic Policy Coordination in EMU', (2009) Centre for European Policy Studies 60

[294] E Lomnicka, 'The Home Country Principle in the Financial Services Directives and the Case Law', in M Andreas, M and W.H. Roth (eds), *Services and Free Movement in EU Law* (Oxford University Press, Oxford, 2003) 296 [had] added

[295] See n 359 above Xv

[296] See n 54 above 5

[297] COM(2005) 629 final, 'White Paper Financial Services Policy 2005-2010'

[298] Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC

[299] M Tison, 'Financial Market Integration in the Post FSAP Era. In Search of Overall Conceptual Consistency in the Regulatory Framework' in G Ferrarini & E Wymeersch (eds) *Investor Protection in Europe: Corporate Law Making, The MiFID and Beyond* (Oxford University Press, Oxford, 2006) 446-448

[300] See n 222 above

[301] See n 299 above 447

[302] See n 193 above

[303] http://www.latimes.com/news/opinion/commentary/la-oe-goldberg10-2009mar10,1,1162545.column (accessed 01-11-2009)

[304] Case C-300/89 *Commission* v *Council* [1991] ECR I-2867

[305] See n 285 above 12

[306] Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes

[307] Case C-233/94 *Germany* v *European Parliament and Council* [1997] ECR I-2405

"there was no need for a Community measure and national steps were sufficient".[308] Their argument was robustly rejected by the ECJ stating that the "principle of home State supervision was not laid down by the Treaty; nor was it laid down by the Community legislature in the sphere of banking law with the intention of systematically subordinating to it all other rules in that sphere".[309]

The creation of the ESA's in the absence of a Treaty amendment, either on the basis of Article 114 TFEU as cited[310] or Article 352 TFEU[311] are strongly supported as these provisions confer broad legislative powers on the Community institutions and render a challenge on the grounds of competence more difficult[312], or through the doctrine of implied powers[313] which provides that the existence of a given power implies the existence of any other power reasonably necessary for the exercise of the former[314], and in the outcome of *Netherlands* v *Parliament and Council*[315] where the ECJ held that if a measure "has immediate effects on intra-Community trade … the objective in question can be better achieved by the Community".[316] Given the Commission's clear position in their recent communication[317] and the position of the De Larosière report[318], there is little doubt that the despite the recent political agreement on implementation "lengthy debates over sovereignty and subsidiarity in the context of EU economic integration"[319] are likely to continue "mainly by countries that sense more to lose than gain from true integration".[320]

5.3 Hypothesis #3 – The recent political agreement highlights the closeness in proximity to sovereignty which mitigated the attempted *anschluss*

The Peace of Westphalia is often hailed as the point in time for a paradigm shift in the development of the present state system, as the first established notion of unity concerning a states' exercise of untrammelled sovereignty over certain territories and subordinated to no

[308] See n 355 above 80
[309] See n 307 above para.12
[310] See n 193 above
[311] See n 15 above
[312] See n 38 above 539
[313] Cases 281, 283-285, 287/85 *Federal Republic of Germany and others* v *Commission* [1987] ECR 3203
[314] T C Hartley, *The Foundations of European Community Law* (6th Edn, Oxford University Press, Oxford, 2007) 105-106
[315] Case C-377/98 *Netherlands* v *European Parliament and Council* [2001]
[316] Ibid para.32
[317] See n 193 above
[318] See n 124 above 11
[319] D Langevoort, 'Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience', in G Ferrarini & E Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, The MiFID and Beyond* (Oxford University Press, Oxford, 2006) 486
[320] Ibid 486

other earthly authority.[321] No word in the debate concerning the EU causes more confusion than the word sovereignty, with students and practitioners analysing the changing nature, even erosion, of the traditional Westphalian concepts of unitary, absolute and legitimate state.[322] It is true that "almost every major nation has been obliged by the pressures of the post-war world, to pool significant areas of sovereignty so as to create more effective political units"[323] specific examples being the World Trade Organisation (WTO), the United Nations (UN) and even North America Treaty Organisation (NATO). This surrender of sovereignty (indeed the surrender itself can be construed as an act of sovereignty[324]) is traded in return for practical gains concerning the national interest, for example, the euro was created with the hope of providing economic benefits for the participant countries while further cementing European integration and containing the power of the Bundesbank.[325] In regards to the EU, the most obvious constitutional change brought about by membership is the surrender of a nation states parliamentary sovereignty to the primacy of Community law.[326] In essence this means that once a competency has transferred by Treaty to the EU, the member state itself is subject to Community law. The issue though is that the Treaty does not contain a neat list demarcating which competencies are exclusive to the EC and which are shared.[327]

History has shown that all polity-building has also been administration building[328] and the new proposals[329] represent a prime example. Taken together with the foregoing considerations concerning the importance of capital[330] and the negotiated derogations around tax[331] the sovereignty question remains as to whether there is a continued willingness within MS to delegate authority to non-majoritarian institutions which fulfil public functions but are not

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321 D Johnston, *The Historical Foundations of World Order* (Koninklijke Brill, Leiden, Netherlands, 2008) 409

322 S Hashmi, 'Introduction' in S Hashmi (ed) *State Sovereignty Change and Persistence in International Relations* (Pennsylvania State University Press, University part, 1997) 1

323 http://www.margaretthatcher.org/document/102692 M Thatcher 'Speech in Hendon (European Referendum Campaign)' (accessed 11-09-2010)

324 K Suter, *Global Order and Global Disorder Globalisation and the Nation State* (Praeger Publishers, Connecticut, 2003) 162

325 K McNamara & S Meunier, 'Between national sovereignty and international power: what external voice for the euro?' (2002) 78(4) International Affairs 849

326 D Watts & C Pilkington, *Britain in the European Union Today* (3rd Edn, Manchester University Press, Manchester, 2005) 115

327 See n 38 above 89

328 J Pollak & S Puntscher Riekmann, 'European administration: Centralisation and fragmentation as a means of polity-building?' (2008) 31(4) West European Politics 771

329 See n 193 above

330 See Chapter 2

331 Article 65 TFEU

directly accountable to voters or their representatives for regulation, information and coordination.[332]

The House of Lords cautions that in the aftermath of the global financial crisis that the "desire for speedy action must not come at the expense of thorough consultation, impact assessment and risk analysis by the Commission in line with their own Better Regulations principles".[333] The German Constitutional Court also makes it clear that the authorisation to transfer sovereign powers to the EU is conditional on the sovereign statehood of a constitutional state being maintained[334] and further that the Basic Law does not grant the German state bodies powers to transfer sovereign powers in such a way that their exercise can independently establish other competences for the EU.[335]

In this regard a view can be formulated that "binding powers for EU regulators would undermine the prerogatives of national oversight bodies".[336] This view is supported by Viscount Trenchard who wrote that European centralisation of financial regulation would progressively compromise the Financial Services Authority/Bank of England's position, inevitably relegating it to the status of a subsidiary of the European bodies and weakening its voice on the world stage.[337] By way of contrast the Turner Review recommended a new European institution should be created which will be an independent authority with regulatory powers, a standard setter and overseer in the area of supervision, and will be significantly involved in macro-prudential analysis[338], however, supervision of individual firms should continue to be performed at national level.[339]

Events coalesced on the evening of September 2nd when the European politocracies reached a compromise with the MS. In essence the compromise protected MS's sovereignty by amending the proposals[340] to include an appeal process against decisions of the ESA's, MS's responsible for declaring emergencies rather than the Commission or the European Parliament, and direct oversight remaining in the hands of national regulators.[341] It can be construed that the result has mitigated the attempted *anschluss* by the politocracy (at least for now) and

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[332] See n 328 above 775
[333] See n 123 above 6
[334] http://www.bundesverfassungsgericht.de/en/press/bvg09-072en.html (accessed 11-09-2010)
[335] Ibid
[336] http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6219945/Germany-wants-to-rein-in-EU-financial-regulation-plans.html (accessed 11-09-2010)
[337] http://www.ft.com/cms/s/0/fa9d03e0-b943-11df-99be-00144feabdc0.html (accessed 11-09-2010)
[338] See n 177 above 9
[339] Ibid
[340] See n 193 above
[341] http://www.ifaonline.co.uk/ifaonline/news/1731136/deal-eu-wide-financial-supervisors-agreed (accessed 11-09-2010)

reinforced the nature of sovereignty as a dynamic entity (given the modifications to the original proposals[342]), highlighting the EU as a federation of States[343] with MS protecting and furthering their interests by establishing the EU in order to perform some of their duties and to exercise some of their sovereignty jointly.[344]

[342] See n 193 above
[343] R Schütze, 'On "Federal" Ground: The European Union as an (Inter)National Phenomenon' (2009) 46 CMLR 1105
[344] D Kommers, *The Constitutional Jurisprudence of the Federal Republic of Germany* (2nd Edn, Duke University Press, North Carolina, 1997) 109

6. Conclusions

In conclusion, while it is recognised that there is a shared rationale for implementing financial regulation[345] there is little direct consensus as to the techniques by which those objectives are to be given effect and for this reason regulatory systems around the world differ[346], from the FSA mega-regulatory model of the UK through to the distributed, even fragmented, model of the US, extant in the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), Department of the Treasury and the Federal Reserve(FED).[347] This paper has shown that initially in order to address the political and operational inhibitors to EU centralised financial regulation and supervision, the politocracy (repeatedly through successive approaches in Segrè[348], Werner[349], SEA[350], FSAP[351], post-FSAP[352]) employed a core rationale couched between the potential financial benefits in GDP terms from a single market[353] in financial services (or latterly a retail financial market[354]) and a public policy concern to protect depositors against the risk of loss and to prevent this loss across the system as a whole.[355] In addition it has been shown that each constituent Member State of the EU is subject to the globalisation of capital and therefore FDI[356]; the fastest growing form of international capital flows and the most important form of private international financing[357]; which increases systemic risk exposures.

By chance (or fate) the global financial crisis intervened to deliver an inflection point, providing an enabling stimulus (arguably the excuse) for the politocracy to readdress the sovereignty and subsidiarity considerations, which for many years resulted in the laggard status of the free movement of capital[358], aptly demonstrated by the diversity of economic policies, the kaleidoscopic regulatory structures, the MS influences over capital inflows and outflows, the national direct control over interest rates, the manipulation of foreign exchange rates and the

[345] See n 209 above 10
[346] See n 207 above 25-42
[347] J Silvia, 'Efficiency and Effectiveness in Financial Regulation: Of Rules and Principles' (2008) 23(28) Washington Legal Foundation 2
[348] See n 139 above
[349] See n 140 above
[350] See n 148 above
[351] See n 54 above
[352] See n 138 above
[353] See n 38 above 609
[354] See n 131 above 353
[355] See n 105 above 66
[356] See n 95 above
[357] See n 98 above 268
[358] See n 40 above 333

availability of credit[359], all of which provide many of the fundamental levers of MS's monetary policy. An argument could be constructed in support of the hypothesis that the original proposals[360] were nothing more than a cynically timed power grab or *anschluss* by the politocracy, but this would be a shallow view given the certainty and coherency benefits that centralisation could bring. It is accepted that the trend globally within nations is towards a centralisation of financial regulation with cross-sector regulatory consolidation[361], and any doubts aired concerning EU centralised regulation and supervision, should not be seen as a signal, by the practitioners, for a return to business as usual.[362] It is clear however, that there must be a reasonable expectation of accountability for any centralised regulator[363] which is perhaps the reason why some of the deficiencies extant in the original proposals[364] have subsequently been addressed - primarily through the appeal facility and the national retention of crisis declaration.[365] However, accountability questions remain with the issues concerning an EU LOLR yet to be addressed.

Operative level mechanisms will address the findings of the innumerable investigations[366] into the recent financial collapse; the general consensus being that "regulators and supervisors focused on the micro-prudential supervision of individual financial institutions and not sufficiently on the macro-systemic risks of a contagion"[367], leaving fault factors such as "weak credit standards, miss-judged maturity mismatches, wildly excessive use of leverage on and off-balance sheet, gaps in regulatory oversight, accounting and risk management practices that exaggerated cycles, a flawed system of credit ratings and weakness of governance"[368]; make it clear that centralised regulation is no panacea, indicating that the issue is with supervision. The compromise approach[369] provides for extant supervisory structures to remain, highlighting regulated financial institutions as being the largest source of the recent financial problems, and pointing out that more regulation is unlikely to resolve the issue.[370] Those operative mechanisms which likely will encapsulate measures designed to address: accounting

[359] See n 142 above Xvii
[360] See n 193 above
[361] See n 311 above 812
[362] http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/1088/1088.pdf (accessed 12-09-2010)
[363] See n 319 above 502
[364] See n 193 above
[365] See n 341 above
[366] See n 56 above, n 120 above, n 123 above, & n 177 above
[367] See n 56 above 11
[368] See n 124 above 13
[369] See n 341 above
[370] See n 318 above 10

valuation rules[371], the problems of pro-cyclicality inherent in Basel II[372], the regulation of credit rating agencies[373], the remuneration of Executive Board members[374], improved audit[375], and the increased use of Non-Operating Holding Company's (NOHCs)[376]; are likely to be easier to implement from a central body.

It remains to outline that one consistent fact prevails throughout this paper, that a perfect institutional structure is unattainable[377] being contingent on numerous design features and policy objectives which are oft metronomic and responding to short-term political imperatives (even panics[378]), especially in the context of national regulation which led to the regulatory diversity exhibited across the EU and inhibited for many years the formation of an Internal Financial Market.[379] From the perspective of the EU, it is unsurprising that the proposals[380] have done little to address the grass-roots operational issues identified in De Larosière Report[381] leaving much still, regardless of centralisation, to debate between the MS and politocracy in terms of the operational consequences of centralised EU financial regulation. However given the recent political compromise[382], the concerns of an *anschluss* are obviated, the sovereignty of MS is reinforced, and the politocracy have achieved EU centralised financial regulation and supervision.

[371] See n 56 above 39-40
[372] See n 124 above 17
[373] See n 123 above 16-17
[374] See n 177 above 79-81
[375] http://web.ifac.org/download/IFAC-G20-Submission_June_2010_Toronto.pdf (accessed 12-09-2010)
[376] See n 56 above 61-65
[377] See n 345 above 155
[378] See n 359 above Xvi
[379] See n 359 above Xv
[380] See n 193 above
[381] See n 318 above
[382] See n 341 above

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Directive 2004/38/EC of the European Parliament and of the Council of 29 April 2004 on the right of citizens of the Union and their family members to move and reside freely within the territory of the Member States

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