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FINANCIAL INTEGRATION IN THE EUROPEAN COMMUNITY

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ABSTRACT

The EC program to complete the internal market is designed to allow the free movement of goods, persons, services, and capital within the Community by the target date of December 31, 1992. This paper provides a comprehensive description and analysis of the EC program for the financial sector, with emphasis on the relationship of this program to overall issues regarding international trade in financial services.

The first section of the paper presents a brief historical survey of the origins of the internal market program. The second section provides an overview of the EC program for creation of a "European Financial Area," a term used by the EC Commission to refer to both the removal of barriers to capital movements and the establishment of a framework for a Community-wide market for financial services. The third section, which is the main focus of the paper, is a conceptual analysis of the internal and external dimensions of the EC program for financial services and markets; the section analyzes the EC approach of mutual recognition as a means of achieving integration of the Community's financial sector and also sets forth a general framework for considering approaches to market access for third-country firms. The fourth section presents the conclusions. A series of appendices provide detailed explanations of the EC programs for banking, investment services, securities markets, and insurance.

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Sydney J. Key*

Over the past year there has been a marked increase in momentum toward completion of the EC internal market--that is, allowing the free movement of goods, persons, services, and capital within the Community--by the target date of December 31, 1992.[1] During 1988, legislation was proposed or adopted by the EC authorities in a number of major areas including liberalization of capital movements and establishment of a framework for a Community-wide market for financial services. National governments are now taking steps to encourage industries to prepare for

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1 The term "European Community" is commonly used to refer to what are actually three distinct European Communities established under separate treaties, namely, the European Coal and Steel Community, the European Economic Community, and the European Atomic Energy Community.

the more competitive post-1992 environment, and some governments are using the deadline to speed deregulation of their own financial markets. In the private sector, companies are developing strategic plans based on the creation of a unified European market; one result has been a wave of intra-European mergers and acquisitions.

Completion of the internal market is expected to create both micro- and macro-economic benefits. An EC-sponsored research study predicts that removal of barriers, including simplification of customs procedures and harmonization of essential standards, together with further integration of the European market will result in downward pressure on costs and prices with a subsequent increase in output and employment within the Community.[2] Provided that the European Community does not erect new external barriers to trade in goods or services, completion of the internal market could also have a positive effect on the United States and other countries outside the Community.[3] In the medium term, if the overall rate of economic growth in the Community increases, EC demand for U.S. exports might be expected to increase.

In the financial sector, the EC program is being developed and implemented at a time of increasing internationalization of financial

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[2] European Economy, special issue on "The Economics of 1992: An assessment of the potential economic effects of completing the internal market in the European Community," no. 35 (March 1988). See generally Tommaso Padoa-Schioppa and others, Efficiency, Stability, and Equity: A Strategy for the Evolution of the Economic System of the European Community (Oxford: Oxford University Press, 1987), pp. 17-31, 118-40.

[3] For example, the harmonization of essential standards could benefit not only EC subsidiaries of U.S. corporations but also U.S. exporters. Such benefits would be jeopardized, however, if the new EC standards were to create barriers by effectively requiring European inputs or production in order for a product to obtain unrestricted access to all of the member states.

services and markets. Technological change and innovation with regard to instruments and services have played a major role in this process. At the same time, market forces have both necessitated and facilitated greater international coordination with regard to supervision and regulation. The results of such coordination include some movement toward a more global harmonization of rules (in particular, the agreement on international bank capital standards[4]) and progress toward liberalization of restrictive rules and practices on the part of individual countries.

The EC program for the financial sector can be viewed as a part of this process of international coordination, although the program is qualitatively different from what has been achieved on a more global basis. Both the EC approach to achieving financial integration within the Community and the approaches it is considering with regard to countries outside the Community are relevant to the problem of developing a conceptual framework for international trade in financial services and merit evaluation from this perspective. EC proposals for treatment of third-country institutions are of interest not only for their potential direct impact on U.S. and other non-EC financial firms and corporate issuers of securities but also in relation to the overall issue of trade in financial services being addressed in various international fora such as the Organisation for Economic Co-operation and Development, the Bank for International Settlements, and the current Uruguay Round of GATT negotiations.

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[4] See <u>infra</u> Sections II.B, IV.

The first section of this paper presents a brief historical survey of the origins of the internal market program. The second section of the paper provides an overview of the EC program for creation of a "European Financial Area," a term used by the EC Commission to refer to both the removal of barriers to capital movements and the establishment of a framework for a Community-wide market for financial services.[5] The third section, which is the main focus of the paper, is a conceptual analysis of the internal and external dimensions of the EC program for financial services and markets; the section analyzes the EC approach of mutual recognition as a means of achieving integration of the Community's financial sector and also sets forth a general framework for considering approaches to market access for third-country firms. The fourth section presents the conclusions. A series of appendices provide detailed explanations of the EC programs for banking, investment services, securities markets, and insurance.

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[5] See Commission of the European Communities, "Communication from the Commission to the Council: Creation of a European Financial Area," COM(87) 550 (November 4, 1987), and European Economy, special issue on "Creation of a European Financial Area," no. 36 (May 1988).

I. 1957-1992: CUSTOMS UNION TO INTERNAL MARKET

A. The Treaty of Rome

The Treaty of Rome, which was signed in 1957, committed the signatories to "establishing a common market and progressively approximating the economic policies of Member States."[6] Although the treaty provided for achieving the free movement of goods, persons, services, and capital within the Community, the initial focus of attention in implementing the treaty was establishment of a customs union, that is, the elimination of all tariffs in intra-Community trade and creation of a common external tariff. This customs union was fully established in 1968, somewhat ahead of the 12-year schedule set out in the Treaty.[7] The focus then shifted to indirect taxes; the culmination of this phase was the adoption in 1977 of a directive harmonizing the base for the value-added tax (VAT) in member states.[8] Creation of the European Monetary System (EMS), which became operative in 1979, was the next major milestone in the process of European integration.[9]

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[6] Treaty establishing the European Economic Community as amended by the Single European Act [hereinafter Treaty of Rome], art. 1. <u>Treaties establishing the European Communities</u>, abridged. (Luxembourg: Office of Official Publications of the European Communities, 1987).

[7] See <u>Steps to European Unity--Community Progress to date: A Chronology</u> (Luxembourg: Office of Official Publications of the European Communities, 1987), p. 36.

[8] Commission of the European Communities, <u>Completing the Internal Market: White Paper from the Commission to the European Council</u> [hereinafter White Paper], para. 5 (Luxembourg: Office of Official Publications of the European Communities, 1985).

[9] See generally Peter Ludlow, <u>The Making of the European Monetary System: A Case Study of the Politics of the European Community</u> (London: Butterworth Scientific, 1982) and Daniel Gros and Niels Thygesen, <u>The EMS: Achievements, Current Issues and Directions for the Future</u>, CEPS Paper no. 35 (Brusssels: Centre for European Policy Studies, 1988).

Despite these achievements, at the end of the 1970s the Community market remained fragmented with a multitude of internal barriers preventing the free movement of goods, persons, services, and capital envisioned by the Treaty of Rome.[10] Although steps had been taken to try to remove some of these barriers, the steps were neither systematic nor part of a clearly articulated overall framework. The enlargement of the Community from six to nine members in 1973 made progress more difficult,[11] and the Community became preoccupied with problems relating to the EC budget and the common agricultural policy.[12] Moreover, during the recessions following the oil price shock of 1974, the use of non-tariff barriers by member states not only against third countries but also against other Community countries increased significantly.[13] The member states also increased substantially their use of subsidies to support otherwise non-viable enterprises.[14]

In the early 1980s, there was widespread concern that, compared with the United States and Japan, the EC countries were recovering very slowly from the recessions of the late 1970s and also that the Community countries were being outstripped by the United States and Japan in the

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[10] See Jean De Ruyt, L'Acte Unique Européen (Brussels: University of Brussels, Institute of European Studies, 1987), p. 22; White Paper, para. 6.

[11] The original six members of the Community were Belgium, France, Germany, Italy, Luxembourg, and the Netherlands. Denmark, Ireland, and the United Kingdom joined the Community in 1973. Greece became a member in 1981, and Portugal and Spain joined in 1986. See Steps to European Unity, supra note 7, pp. 48, 68, 84.

[12] The problem of the British contribution to the Community budget became a major issue in the late 1970s and was not resolved until 1984. See Jean De Ruyt, supra note 10, pp. 25-28.

[13] White Paper, para. 6, and Jean De Ruyt, supra note 10, p. 22.

[14] White Paper, para. 6.

new high-technology industries. The conventional wisdom was that non-tariff barriers and market fragmentation within the Community were major impediments to EC economic growth.[15] Partly as a result of this view, in the first half of the 1980s a number of new initiatives were proposed to relaunch the process of European integration.[16] Perhaps the most far-reaching of these was the draft treaty establishing a European Union adopted by the European Parliament in early 1984.[17] Although this treaty had no chance of being ratified by the member states, it served to encourage the EC heads of states, who had previously renewed their commitment in general terms to the goals set forth in the Treaty of Rome, to take concrete action toward completion of the internal market, action that took the form of amending the Treaty of Rome.[18]

Steps toward further integration of the market also became easier to achieve by the mid-1980s because a period of sustained economic growth had begun in most of the Community countries after the recovery from the 1982 recession. Moreover, the political situation had changed with the coming into power of governments in the United Kingdom (in 1979) and in Germany (in 1982) that were more strongly committed to free markets than were their predecessors.

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[15] See M. Albert and R.J. Ball, "Towards European Economic Recovery in the 1980s: Report presented to the European Parliament," rev. ed., 1983-1984 Eur. Parl. Doc. (August 31, 1983); Jean De Ruyt, supra note 10, p. 25. But see also Robert Z. Lawrence and Charles L. Schultze, eds., Barriers to European Economic Growth: A Transatlantic View (Washington: The Brookings Institution, 1987).

[16] Jean De Ruyt, supra note 10, pp. 25-45.

[17] Draft Treaty establishing the European Union, 17 Bulletin of the European Communities (No. 2) 7 (1984). See also Roland Bieber, Jean-Paul Jacqué, and Joseph H. H. Weiler, An Ever Closer Union: A critical analysis of the Draft Treaty establishing the European Union (Brussels: Commission of the European Communities, 1985).

[18] See infra pp. 11-14.

B. The White Paper and the Single European Act

All of these political and economic developments created an environment in which the new Commission that took office at the beginning of 1985, with Jacques Delors as its president, could move forward with proposals for economic integration.[19] By mid-1985, Lord Cockfield, the new Commissioner responsible for the internal market, had prepared a White Paper on Completing the Internal Market, which was subsequently adopted by the Council and became the basis for the entire EC internal

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[19] The Commission is the executive branch of the Community government and has responsibility for proposing legislation and for ensuring implementation of Community law by the member states. Commissioners are appointed by agreement among the governments of the member states for four year terms.

The Council of Ministers is the decision-making body and enacts legislation proposed by the Commission. The presidency of the Council rotates among member states every six months. Participants at Council meetings change on the basis of the subject being considered. For example, if banking legislation is being considered, the Council participants are the economic and finance ministers. The "European Council" consists of the heads of state and government and meets semiannually.

The European Parliament, which is elected directly by the citizens of the member states, has an extremely limited legislative function. However, it does have final approval over the EC budget and, with regard to other matters, has a consultative role in Council decisions.

The European Court of Justice consists of 13 judges appointed by agreement among the governments of the member states for six-year terms. In general, the Court has original jurisdiction in cases in which the Commission or another Community institution is a party. Other actions are brought in national courts but referred to the European Court of Justice for preliminary rulings on matters of EC law; such rulings are binding on the national courts. (An EC Court of First Instance was created in 1988 to hear actions brought against Community institutions by EC staff or by private parties in certain technical areas; the European Court of Justice has appellate jurisdiction in such cases.)

See Emile Noël, Working Together--The Institutions of the European Communities (Luxembourg: Office of Official Publications of the European Communities, 1988).

market program.[20] The White Paper identified 300 pieces of legislation (later revised to 279) that would need to be enacted by the Community in order to remove restrictions or to harmonize laws of member states and set forth a timetable for enactment of each proposal that called for the entire program to be in place by the end of 1992.[21]

The White Paper also announced a new strategy regarding harmonization. Instead of the previous approach, under which an unsuccessful attempt had been made to achieve complete harmonization of standards at the Community level, the Commission adopted a new approach involving harmonization of only essential laws and regulations (such as

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[20] See <u>supra</u> note 8.

[21] EC legislation can be in the form of regulations or directives. A <u>regulation</u> is binding in its entirety and directly applicable throughout the Community without any implementing legislation by the member states. By contrast, a <u>directive</u> is addressed to the member states, which are obligated to ensure that the result set forth in the directive is achieved but have discretion as to the details of implementation. Treaty of Rome, art. 189.

Most of the EC internal market legislation is in the form of directives. Each directive specifies a date by which member states must conform their national laws to the provisions of the directive; typically a period of two years is allowed. Therefore, in order to complete the internal market by the end of 1992, directives would need to be adopted by the end of 1990. See <u>infra</u> pp. 14-16 for a summary of the legislative program.

If a member state does not conform its laws in accordance with an EC directive, not only the EC Commission but also an individual or company may take legal action against the member state. An individual or company may invoke rights under EC law in national courts under the principle of "direct effects," which was developed by the European Court of Justice and has become an important mechanism for ensuring implementation of EC legislation. See Alan Dashwood, "The Principle of Direct Effect in European Community Law," <u>Journal of Common Market Studies</u>, vol. 16 (September 1978), pp. 229-45, and J. Steiner, "Direct Applicability in EEC Law-A Chameleon Concept," <u>The Law Quarterly Review</u>, vol. 98 (April 1982), pp. 229-48.

those affecting health and safety) for both goods and services.[22] Under the Commission's approach, the harmonization of essential standards provides the basis for "mutual recognition" by the member states of the equivalence and validity of each other's laws, regulations, and administrative practices that have not been harmonized at the EC level.[23] An essential element of such recognition is agreement not to invoke differences in national rules for the purpose of restricting free access of goods and services.[24]

A 1979 decision by the European Court of Justice interpreting the Treaty of Rome provided, at least with regard to products, the legal basis for the Commission's approach of mutual recognition.[25] In Cassis de Dijon, the Court found that Germany could not prohibit the import of a liqueur that was lawfully produced and sold in France solely because its alcohol content, which was clearly labeled, was too low for it to be deemed a liqueur under German law.[26] The Court said that, even though (German) national rules would have applied equally to domestic and

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[22] White Paper, paras. 65-79. In the product area, detailed harmonization of specifications was left to the existing European standardization bodies. White Paper, paras. 68-72.

[23] White Paper, para. 77. The term mutual recognition was used in the Treaty of Rome only with regard to professional qualifications. Specifically, the Treaty called for the Council to issue directives for "the mutual recognition of diplomas, certificates and other evidence of formal qualifications." Treaty of Rome, art. 57. See infra Section III.A. regarding use of the principle of mutual recognition in the financial sector.

[24] White Paper, para. 77.

[25] The article at issue prohibits in trade between member countries "quantitative restrictions on imports and all measures having equivalent effect." Treaty of Rome, art. 30.

[26] Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein [hereinafter Cassis de Dijon] (Case 120/78), [1979] ECR 649, [1979] CMLR 494.

imported products, a member state may create a barrier to the import of a product only when it is necessary to satisfy "mandatory requirements" such as the need to control tax evasion, the protection of public health, the fairness of commercial transactions, and the protection of consumers.[27] Moreover, any such rule must be an "essential guarantee" of the interest that is allowed to be protected.[28] Absent such a justification, a member state may not apply its own national rules to imported products.

In other words, although the Court did not use the term, member states must accord mutual recognition to the laws of other member states regarding production and sale of a product. In subsequent judgments overturning British standards for milk,[29] German standards for beer,[30] French standards for milk,[31] and Italian standards for pasta,[32] the Court has continued to apply the test set forth in Cassis de Dijon. With these decisions, as in other areas, the Court has continued to play an important role in the implementation of the internal market program.

Both the White Paper's goal of implementing the internal market by 1992 and the approach of mutual recognition were included in provisions of the Single European Act, a 1986 agreement among the EC

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27 Cassis de Dijon, [1979] ECR at 662.

28 Id. at 664.

29 Commission of the European Communities v. United Kingdom of Great Britain and Northern Ireland (Case 124/81), [1983] ECR 203, [1983] CMLR 1.

30 Re Purity Requirements for Beer: EC Commission v. Germany (Case 178/84), [1988] CMLR 780.

31 Commission of the European Communities v. Republic of France (Case 216/84), judgment of February 23, 1988 [not yet reported in English].

32 Drei Glocken GmbH and Kritzinger v. U.S.L. Centro-Sud and Provincia Autonoma di Bolzano (Case 407/85), judgment of July 14, 1988 [not yet reported in English].

member states that amended the Treaty of Rome.[33] The Single European Act, like the Cassis de Dijon judgment, does not use the term mutual recognition but provides that the Council "may decide that the provisions in force in a Member State must be recognized as being equivalent to those applied by another Member State."[34]

A major purpose of the Single European Act, which became effective in July 1987, was to make the EC decision-making process more efficient and thereby facilitate the completion of the internal market. To this end, the Single European Act replaced unanimous voting by "qualified majority voting" for adoption by the Council of most harmonization measures necessary to achieve the internal market.[35] However, fiscal measures such as harmonization of taxes still require unanimous approval.[36]

Other institutional provisions of the Single European Act were designed to increase the role of the European Parliament in the EC decision-making process. However, the Parliament's role remains

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[33] Single European Act, arts. 13, 19. Treaties establishing the European Communities, abridged (Luxembourg: Office of Official Publications of the European Communities, 1987).

[34] This authority is granted in the context of a provision requiring the Commission, together with the member states, to draw up during 1992 an inventory of national laws, regulations, and administrative provisions within the scope of the internal market program that have not been harmonized. Id., art. 19.

[35] Id., art. 18. Under qualified majority voting, the number of votes that each member state exercises in the Council is weighted roughly according to its population. The United Kingdom, Germany, France, and Italy have ten votes each, Spain has eight, the Netherlands, Portugal, Greece, and Belgium have five each, Ireland and Denmark three, and Luxembourg two. Fifty-four votes (out of a total of 76) are required to adopt legislation. Treaty of Rome, art. 148.

[36] Single European Act, art. 17.

primarily consultative rather than legislative. Under the new "co-operation procedure," which applies to measures involving harmonization, amendments proposed by the Parliament must be taken into account by the Commission and the Council. However, a Parliamentary amendment that is not supported by the Commission requires unanimous approval by the Council. A measure that is rejected in its entirety by the Parliament may be enacted by the Council only by unanimous vote.[37]

The Single European Act also set forth goals in other areas that had either been stated much more generally or not included in the Treaty of Rome. In the monetary area, the Single European Act committed the member states to further cooperation and, if necessary, to institutional changes "[i]n order to ensure the convergence of economic and monetary policies."[38] The Act also committed the member states to encouraging improvements in the area of social policy with regard to the health and

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[37] The co-operation procedure works as follows: The Commission submits a proposal to the Council and at the same time sends it to the Parliament for a first reading. After obtaining Parliament's opinion, the Council adopts a "common position." The Council must then submit its common position to Parliament for a second reading.

If the Parliament accepts the proposal (or fails to act within a three month period), the Council must adopt the measure in accord with its common position.

If the Parliament rejects the Council's common position, the Council may adopt the proposal only by a unanimous vote.

If the Parliament proposes amendments, within one month the Commission must "re-examine" the proposal and submit to the Council a revised proposal that either incorporates the Parliament's amendments or provides a justification for their omission. The Council may adopt the Commission's revised proposal by a qualified majority. Unanimity is required for the Council to adopt Parliamentary amendments that were not accepted by the Commission or otherwise to amend the Commission's revised proposal. If the revised proposal is not adopted by the Council within three months, the proposal is deemed not to have been adopted.

Single European Act, arts. 6, 7; see also Emile Noël, supra note 19, pp. 35-36.

[38] Single European Act, art. 20. See also infra Section II.A.

safety of workers,[39] to strengthening the "economic and social cohesion" of the Community (i.e., reducing regional disparities),[40] to promoting research and technological development,[41] and to preserving the environment.[42]

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[39] Id., art. 21.

[40] Id., art. 23.

[41] Id., art. 24.

[42] Id., art. 25.

C. The Legislative Program for Completing the Internal Market

In its 1985 White Paper, the Commission classified the measures that would be necessary to complete the internal market into three groups:

(1) **removal of physical barriers** such as customs checks at frontiers for goods and for individuals;[43]

(2) **removal of technical barriers** such as differences in essential national health and safety standards for individual products; other goals include open access for bidding on public contracts, removal of restrictions on capital movements, removal of restrictions and harmonization of essential standards for provision of financial services, recognition of educational and professional qualifications, abolishing cartels in the field of transportation, establishing a Community policy for mergers and acquisitions, establishing a Community trade mark and patent system, and developing a uniform policy on government subsidies;[44]

(3) **removal of fiscal barriers** such as differences in value-added tax rates.[45]

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[43] White Paper, paras. 24-56. See also Commission of the European Communities, "Completing the Internal Market: An Area without Internal Frontiers--The Progress Report Required by Article 8B of the Treaty," COM(88) 650 final (November 17, 1988) [hereinafter Progress Report], pp. 21-23 and Europe without frontiers: Completing the internal market, 2d ed. (Luxembourg: Office of Official Publications of the European Communities, 1988), pp. 31-38.

[44] White Paper, paras. 57-158. See also Progress Report, pp. 15-21, and Europe without Frontiers, supra note 43, pp. 39-51.

[45] White Paper, paras. 160-218. See also Progress Report, p. 24, and Europe without Frontiers, supra note 43, pp. 53-59.

Progress with regard to completion of the internal market has been impressive, particularly because only a few years ago what has already been achieved was generally viewed as unachievable. As of March 1989, the Commission had submitted to the Council more than four-fifths of the 279 pieces of legislation identified in the White Paper.[46] Although the Council is considerably behind the schedule set forth in the White Paper for acting upon this legislation, during 1988 and the first quarter of 1989 it made substantial progress in dealing with its backlog of Commission proposals. As of March 1989, the Council had taken final action on 113 legislative proposals (with five additional measures awaiting final action) and reached a common position on another fourteen proposals.[47] However, some of the remaining proposals, for example, harmonization of indirect taxes and removal of border controls, are particularly complicated or controversial. If the 1992 deadline is to be met, the Council must complete its work on the directives by the end of 1990 in order to allow time for implementation by the member states.[48]

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[46] Commission of the European Communities, "Completion of the Internal Market Statistics," March 22, 1989.

[47] Id. See supra note 37 for explanation of "common position."

[48] See supra note 21.

II. CREATION OF A "EUROPEAN FINANCIAL AREA"

A. Removal of Restrictions on Capital Movements

The removal of barriers to capital movements is a critical element of the EC plan for financial integration since, without free movement of capital, both the integration of securities markets and the cross-border provision of financial services would be impossible. Restrictions on movements of capital imposed by EC countries have already been reduced significantly as a result of a lengthy process that began in the early 1960s,[49] was set back by measures taken by member states during the economic difficulties of the 1970s, and was reactivated in the early 1980s by a major Commission initiative.[50] The process of liberalization of capital movements culminated with the enactment in 1986 of a measure to remove remaining restrictions on capital movements directly related to trade and investment[51] and enactment in June 1988 of

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[49] See First Council Directive of 11 May 1960 for the implementation of Article 67 of the Treaty, 1959-1962 (English special edition) O.J. Eur. Comm. 49; Second Council Directive of 18 December 1962 adding to and amending the First Directive for the implementation of Article 67 of the Treaty, 1963-1964 (English special edition) O.J. Eur. Comm. 5.

[50] See Commission of the European Communities, "Financial Integration: Communication from the Commission to the Council," COM(83) 207 final (April 20, 1983).

[51] Council Directive of 17 November 1986 amending the First Directive of 11 May 1960 for the implementation of Article 67 of the Treaty (86/566/EEC), 29 O.J. Eur. Comm. (No. L 332) 22 (1986). See also Council Directive of 20 December 1985 amending the Directive of 11 May 1960 on the implementation of Article 67 of the Treaty (85/583/EEC) 28 O.J. Eur. Comm. (No. L 372) 39 (1985). See Commission of the European Communities, "Communication from the Commission to the Council: Programme for the Liberalization of Capital Movements in the Community," COM(86) 292 final (May 23, 1986), for an overview.

a directive to eliminate all remaining controls.[52] As a result, barriers to movements of capital will be eliminated by most of the EC countries by July 1, 1990.[53]

At present, four countries--the United Kingdom, Germany, the Netherlands, and Denmark--have fully liberalized capital movements vis--vis both other member states and third countries. The four additional countries--Belgium, Luxembourg, France, and Italy--that must remove all remaining controls by the 1990 deadline are already close to doing so. The capital controls still imposed by these countries include the dual exchange rate system operated by Belgium and Luxembourg,[54] French restrictions on accounts held abroad by residents,[55] and Italian restrictions associated with the foreign exchange monopoly of the central

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[52] Council Directive of 24 June 1988 for the implementation of Article 67 of the Treaty (88/361/EEC) [hereinafter Council Directive of 24 June 1988], 31 O.J. Eur. Comm. (No. L 178) 5 (1988). See Commission of the European Communities, "Proposal for a Council Directive for the Implementation of Article 67 of the EEC Treaty: Liberalization of Capital Movements," COM(87) 550 final (November 4, 1987), for explanatory memorandum.

[53] The Community has provided an extended deadline of 1992 for Spain, Ireland, Portugal, and Greece with an additional extension of up to three years (to be decided in 1992) possible for Portugal and Greece.

[54] Under the Belgium-Luxembourg dual exchange rate system, transactions relating to trade and direct investment are conducted on the official market, which sets the rate for purposes of the EMS, while other transactions (i.e., short term capital transactions) are conducted on the free market. In practice, the rates on the two markets have been very similar in recent years, and the system has not had the effect of restricting capital movements. As a result, Belgium and Luxembourg are not legally required to abolish the system until the end of 1992; however, in the interim, they are required to ensure the *de facto* free movement of capital such that the exchange rates on the two markets "show no appreciable and lasting differences." Council Directive of 24 June 1988, Annex V.

[55] In March 1989, France removed all but one of its few remaining exchange controls. The only remaining restriction prohibits nonbank residents not involved in international commercial activities from holding deposits at banks in foreign countries or foreign currency deposits (other than those denominated in ECUs) at banks in France.

bank and requirements for special accounts for residents conducting international transactions.[56]

Treatment of non-EC countries. With regard to third countries, the 1988 directive contains a provision stating that the EC countries will "endeavor to attain the same degree of liberalization" of capital movements that applies within the Community to capital movements to and from non-EC countries.[57] However, the directive also states that this provision shall not prevent the application to non-EC countries of any reciprocity conditions in Community law or in the present domestic laws of the member states. The directive mentions in particular the areas of direct investment, provision of financial services, and the admission of securities to capital markets.[58] In the event of severe problems with respect to monetary flows or exchange rate developments between one or more member states and a non-EC country, a mechanism is set up for the member states to consult on any measure to be taken.[59]

Safeguards. In response to concerns of some member states, the Community included "safety nets" in the plan for removal of remaining

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[56] In October 1988, Italy introduced a reform of its exchange controls based on the principle that a transaction is permissible unless it is specifically prohibited. (Previously, the converse had been true.) However, the Bank of Italy retains its foreign exchange monopoly. In connection with this monopoly, Italian authorities under their discretionary powers still impose an obligation to surrender foreign exchange holdings, a ban on residents' holdings of deposits abroad, and some restrictions on the foreign currency positions and net external positions of banks authorized to deal in foreign exchange. Italy still requires market participants to conduct their external transactions through these authorized banks and to deal through and with such banks when buying and selling foreign exchange.

[57] Council Directive of 24 June 1988, art. 7.

[58] Id.

[59] Id.

capital controls. One is creation of a new medium-term loan facility for member states with balance-of-payments difficulties.[60] Another is a safeguard clause that permits a member state to reimpose controls in the event of a serious exchange crisis.[61] Under this provision, subject to subsequent approval by the Commission, a member state could reimpose controls for a maximum of six months. The need for this safeguard procedure will be reviewed by the Council in 1992.

Because the Community is already very close to achieving free movement of capital, the concern about safeguards appears to stem not from a belief that the lifting of the remaining controls would trigger a crisis but from a concern that, if an exogenous shock were to occur, the absence of any restrictions on capital movements combined with a commitment not to impose such restrictions could create a crisis. As long as capital is free to move in some way in response to market forces, it is unlikely that the opening of an additional channel for such movement would, by itself, precipitate a major outflow.

Historical experience tends to support this view. When the United Kingdom lifted all of its exchange controls in 1979, a disruptive outflow of capital did not occur and there was no unwarranted downward pressure on the British pound. As far as can be determined, there was no significant increase in tax evasion.[62] However, it has been suggested that the relevance of the British experience a decade later may be

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[60] Council Regulation (EEC) No. 1969/88 of 24 June 1988 establishing a single facility providing medium-term financial assistance for Member States' balances of payments. 31 O.J. Eur. Comm. (No. L 178) 1 (1988).

[61] Council Directive of 24 June 1988, art. 3.

[62] See David Buchan, "Cross-border investors to face tax threat from EC," Financial Times, February 2, 1989, pp. 1, 16.

limited because of the increased efficiency of capital markets and the lower transactions costs of international banking. Japan was concerned about the possible impact of the measures taken during the period from 1980 to 1984 to liberalize transactions denominated in yen, but, despite substantial capital flows associated with Japan's large and persistent current account surplus, private capital market transactions subsequent to removal of the restrictions have not proved disruptive.

Nevertheless, countries such as France and Italy are concerned that the removal of their remaining exchange controls will create a serious potential for tax evasion because of existing differences in taxes on interest and dividend payments.[63] At present, there is considerable divergence within the Community with regard to such taxes; for example, Luxembourg does not impose any withholding tax on interest or dividend payments (to either residents or nonresidents) while rates in other countries are as high as 35 percent.[64] France in particular fears that individual French residents will open bank accounts in other Community countries in an attempt to avoid paying home-country taxes on

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[63] The EC Commission notes that capital outflows with an associated loss of potential tax revenues preceded the imposition at the beginning of 1989 of a 10 percent withholding tax by Germany and of a new automatic reporting of interest payments by Dutch banks to the national tax authorities. Commission of the European Communities, "Tax Measures to be Adopted by the Community in Connection with the Liberalization of Capital Movements (Communication from the Commission to the Council)" [hereinafter Communication regarding Withholding Taxes], COM(89) 60 final (February 8, 1989), para. 7.

[64] It should be noted that nominal withholding tax rates do not necessarily give an indication of tax incentives for foreign residents because, in addition to statutory exemptions for certain types of interest, such taxes are often reduced or eliminated by bilateral tax treaties.

the interest income.[65]

In order to address such concerns, the Commission has submitted proposals that would require member states to impose a minimum withholding tax of 15 percent on interest income paid to any EC resident (whether an EC or third-country national) on domestically-issued bonds and bank deposits.[66] The member states would be free to exempt certain categories of interest such as interest on Eurobonds, interest on interbank deposits, and interest paid to non-EC residents; dividend payments are not covered by the proposal.[67] The Commission's proposals also include measures for increased cooperation among the tax authorities of the member states.[68] In developing its proposals, the Commission rejected an alternative approach that would have required banks to provide information about the recipients of interest payments to national

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[65] Under the French tax system, banks play a particularly important role in preventing tax evasion by recipients of interest income.

[66] Commission of the European Communities, Proposal for a Council Directive on a common system of withholding tax on interest income," [hereinafter Proposed Withholding Tax Directive] COM (89) 60 final (February 8, 1989). At the insistence of France, the 1988 directive that removed remaining capital controls contained a provision requiring the Commission to submit a proposal to deal with potential tax evasion before the end of 1988 and the Council to adopt a common position by the end of June 1989. Council Directive of 24 June 1988, art. 6. See <u>supra</u> note 37 for explanation of common position.

[67] Eurobonds were exempted because of concern that imposition of the tax would cause the Eurobond business to be shifted outside the Community. Proposed Withholding Tax Directive, art. 5. The proposal also permits member states that have a system of automatic declaration of interest payments by banks to the tax authorities to exempt their own residents from the withholding tax. <u>Id</u>. Dividend income is not covered by the Commission's proposal because national withholding tax or tax credit systems currently in place were considered to provide adequate protection against tax evasion. Communication regarding Withholding Taxes, para. 6.

[68] Commission of the European Communities, "Proposal for a Council Directive amending directive 77/799/EEC concerning mutual assistance by the competent authorities of the member states in the field of direct taxation and value added tax," COM (89) 60 final (February 8, 1989).

tax authorities primarily because of the potential conflict with bank secrecy laws in some of the member states.[69]

The Commission's proposals are extremely controversial, and it is not clear whether, or in what form, they will be adopted.[70] As is the case for other fiscal matters, the Council would be required to adopt such proposals by a unanimous vote. Because the Commission's proposal would establish a rate of withholding tax higher than current rates in some Community countries, imposition of such a tax could provide an incentive for EC residents to move funds out of the Community, for example, to Switzerland, or to an offshore center within the Community such as the Channel Islands, which are not covered by the directive. The Community's longer run goal, should the Commission proposal be adopted, is to seek agreement with major countries outside the Community, either bilaterally or within the framework of the Organisation for Economic Co-operation and Development, on a more global uniform minimum withholding tax and on increased cooperation among national tax authorities.[71]

Monetary integration. Beyond financial integration, the liberalization of capital movements, together with other aspects of the internal market program, raises the issue of exchange rate relationships among the member states. Within the Community there is considerable debate as to whether increased coordination of monetary policy and

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69 Communication regarding Withholding Taxes, para. 15.

70 Luxembourg and the United Kingdom have already announced their opposition in principle to the Commission's proposal. David Buchan, "Plans for EC minimum savings tax get rough ministerial ride," Financial Times, February 14, 1988, p. 1. See also "Hold off withholding," editorial, Financial Times, February 9, 1989, p. 18.

71 Communication regarding Withholding Taxes, para. 25.

strengthening of the EMS will be sufficient to ensure exchange rate stability or whether it will be necessary to establish an economic and monetary union.

The traditional definition of an economic union would be satisfied by completion of the internal market. However, in the context of the European Community, the term is used more broadly to encompass also some form of coordinated or perhaps centralized decision making regarding macro-economic policy objectives. A true monetary union would require both irrevocably fixed exchange rates, which could take the form of a common currency, and some mechanism for conducting a common monetary policy, perhaps a European Central Bank. At the Hanover summit meeting in June 1988, the EC heads of state decided to establish a committee of experts to study and propose "concrete stages" leading toward "realization of Economic and Monetary Union."[72] The report of the committee is expected to be released in the near future and will be considered by the EC heads of state at their June 1989 summit meeting in Madrid. In any event, while economic and monetary union might be a possible longer-run consequence of the completion of the internal market, achievement of such a union is not a part of the internal market program.

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[72] Conclusions of the European Council, Hanover, June 27-28, 1988, European Community News, no. 18/88 (Washington: EC Office of Press and Public Affairs), pp. 4-5.

B. Financial Services and Markets

The EC program to complete the internal market includes a comprehensive program for the financial sector that is designed to provide sufficient harmonization of essential rules to permit mutual recognition of the equivalence and validity of national rules and practices that have not been harmonized and acceptance of home-country control. The principle of mutual recognition will be analyzed in depth in Section III.A below; the purpose of this section is to provide an overview of the EC program for financial services and markets, including the EC reciprocity proposals. More detailed explanations of the programs in each area are contained in the appendices.

Banking. The Second Banking Directive, which was proposed by the Commission in 1988 and is expected to be enacted during 1989, is viewed as the centerpiece of EC banking legislation because it is a comprehensive proposal dealing with the powers and geographic expansion of banks within the Community.[73] Under this directive, a credit institution would be able to provide services throughout the Community--either through branches or across borders--under home-country control without the necessity of obtaining an authorization from the host

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[73] Commission of the European Communitites, "Proposal for a Second Council Directive 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" [hereinafter Proposed Second Banking Directive], COM(87) 715 final (February 16, 1988). As of this writing, the European Parliament had completed its first reading of the directive, and the Commission had just released its revisions to the proposed reciprocity provision.

country.[74] The directive also sets forth a list of permissible activities that is based on a universal banking model and includes all forms of securities activities, but not insurance activities. If a bank's home country permits a listed activity, the bank may conduct that activity anywhere in the Community regardless of host-country law.

The Commission proposes to implement the Second Banking Directive no later than January 1, 1993, simultaneously with measures to harmonize bank capital standards based on the framework developed by the Basle Committee on Banking Regulations and Supervisory Practices.[75] These measures comprise the "own funds" directive, which defines capital

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[74] "Cross-border services" refers to the provision of services by a credit institution located in one member state to consumers of these services in another member state without the establishment of a branch in the host state. Within the European Community, prior to the recent series of measures to remove remaining exchange controls (see supra Section II.A), such controls were a major barrier to the provision of banking services across borders. However, at present, some host-country restrictions on products or instruments as well as national rules prohibiting solicitation of business by foreign entities also have the effect of limiting the provision of banking services across borders.

[75] The Basle Committee includes the bank supervisory authorities from twelve major industrial countries, namely, Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. The Basle guidelines provide for partial implementation of minimum risk-adjusted capital ratios by year-end 1990 and full implementation by year-end 1992. See BIS Committee on Banking Regulations and Supervisory Practices, "International Convergence of Capital Measurement and Capital Standards" (Basle: Bank for International Settlements, July 1988). See also Federal Reserve System Final Risk-Based Capital Guidelines, 54 Fed. Reg. 4186 (January 27, 1989) (Appendix A to 12 C.F.R. Part 298 and 12 C.F.R. Part 225).

and was approved by the Council in December 1988,[76] and the solvency ratio directive, which specifies risk-adjusted capital ratios and has not yet been acted upon by the Council.[77]

Investment services. The EC program for the securities sector encompasses two distinct areas: first, rules applicable to firms offering investment services to their customers; and second, rules applicable to markets on which securities are traded. In general, the latter area involves more traditional objectives of investor protection and efficient market functioning, while the former involves systemic risks comparable to those in banking.[78]

The investment services area is particularly difficult because, in contrast to banking, the process of global harmonization is much less advanced. In particular, there is no equivalent of the Basle Accord on bank capital standards for securities firms. Also, unlike the situation for the banking sector, the regulatory structures for investment services in the member countries are much more divergent, and a committee of

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[76] Common Position adopted by the Council on 21 December 1988 with a view to the adoption of the Council directive on the amended proposal for a Council directive on the own funds of credit institutions, no. 4020/89 (January 6, 1989).

[77] Commission of the European Communities, "Proposal for a Council Directive on a solvency ratio for credit institutions," COM(88) 194 final (April 20, 1988). In contrast to the Basle guidelines, the EC proposal does not provide for partial implementation of capital ratios by year-end 1990; thus, under the EC directive, the five EC countries that are not members of the BIS Committee would not be required to meet the interim deadline.

[78] See Organisation for Economic Co-operation and Development, "Arrangements for the Regulation and Supervision of Securities Markets in OECD Countries," Financial Market Trends, no. 41 (Paris: OECD, November 1988), pp. 17-38.

regulators from different countries comparable to the BIS Committee on Banking Regulations and Supervisory Practices does not exist. Moreover, in the investment services area, even more so than in the banking area, the European Community is confronted with the problem of trying to harmonize essential elements of national regulatory frameworks at a time when those frameworks themselves are in the process of changing in response to the ongoing processes of globalization and innovation in the financial sector.[79]

The investment services directive that is the counterpart of the Second Banking Directive was proposed by the Commission in December 1988.[80] Under this directive, investment firms, like credit institutions, would be able to provide services across borders and establish branches throughout the Community without obtaining authorization from the host country. In order to ensure that investment firms are able to compete effectively in the host country, the directive also provides for liberalization of rules governing access to stock exchanges and to financial futures and options exchanges.

The Commission is still in the process of trying to develop a market risk directive that would be the equivalent of the capital adequacy directives for banking institutions. Such a directive is

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[79] See Tommaso Padoa-Schioppa, "The Blurring of Financial Frontiers: in Search of an Order," paper presented at Commission of the European Communities Conference on Financial Conglomerates (Brussels, March 14-15, 1988), for a discussion of regulatory approaches to financial services.

[80] Commission of the European Communities, "Proposal for a Council Directive on investment services in the securities field" [hereinafter Proposed Investment Services Directive], COM(88) 778 (December 16, 1988).

expected to come into force simultaneously with the proposed Investment Services Directive. The interaction of the banking and investment services directives with regard to the securities activities of banking institutions is somewhat complicated and not yet completely developed.[81] It is anticipated that the capital requirements for investment firms that will be contained in the market risk directive will also apply to the securities activities of banks.[82]

Securities markets. The European Community's movement toward harmonization of basic standards and mutual recognition of remaining differences in rules for securities markets can be viewed as part of a more global trend toward integration of securities markets. Within the Community, a number of directives have been enacted or proposed with the objective of breaking down the barriers between national stock exchanges by both increasing transparency and ensuring access for issuers to securities markets throughout the Community.[83]

One group of measures deals with listed securities and includes a directive providing for mutual recognition of the "listing particulars" (i.e., disclosure documents) of the company's home country.[84] A directive dealing with unlisted securities (other than Eurosecurities),

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[81] See infra Appendices A, B.

[82] See infra Appendix B.

[83] See infra Appendix C.

[84] Council Directive of 22 June 1987 amending Directive 80/390/EEC coordinating the requirements for the drawing-up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing (87/345/EEC) [hereinafter Mutual Recognition Amendment to Listing Particulars Directive], 30 O.J. Eur. Comm. (No. L 185) 81 (1987).

which was adopted by the Council in December 1988, provides for mutual recognition of prospectuses.[85] A directive regarding cross-border sales of one particular product--open-ended unit trusts or "undertakings for collective investment in transferable securities" (UCITS)--will become effective in October 1989.[86] At that time, UCITS that meet the minimum standards set forth in the directive may be sold throughout the Community under home-country control.

Insurance. In contrast to the banking and securities sector, the insurance industry in the European Community, with the exception of the United Kingdom, has been relatively protected from outside competition and has not been part of any globalization process.[87] As a

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[85] Council of the European Communities, "Common position adopted by the Council on 21 December 1988 on the amended proposal for a Council directive co-ordinating the requirements for the drawing up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public," [hereinafter Mutual Recognition of Prospectuses Directive], no. 4017/89, January 5, 1989.

[86] Unit trusts are similar but not identical in legal form to mutual funds. (Money-market mutual funds are not covered by the directive.) Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provision relating to undertakings for collective investment in transferable securities (UCITS) (85/611/EEC) [hereinafter UCITS Directive], 28 O.J. Eur. Comm. (No. L 375) 3 (1985); Council Directive of 22 March 1988 amending, as regards the investment policies of certain UCITS, Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investments in transferable securities (UCITS) (88/220/EEC), 31 O.J. Eur. Comm. (No. L 100) 31 (1988).

[87] See infra Appendix D regarding restrictions on provision of insurance services imposed by EC member states. Reinsurance, which has traditionally been an international business, is the exception. See Council Directive of 25 February 1964 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of reinsurance and retrocession (64/225/EEC), 1963-1964 (English special edition) O.J. Eur. Comm. 131.

result, existing barriers to creation of a Community-wide regulatory framework for insurance are much greater than in the rest of the financial sector, and it appears to be politically necessary for the Community to proceed more slowly in the insurance area in achieving sufficient harmonization to permit mutual recognition and home-country control. Accordingly, the insurance directives that were proposed or adopted in 1988 are much less far reaching than those for banking and investment services.

In contrast to the banking and investment services directives proposed in 1988, both the Second Non-life Insurance Directive (enacted in 1988) and the proposed Second Life Insurance Directive deal only with cross-border provision of services and do <u>not</u> provide for Community-wide branching of insurance companies under home-country control.[88] Unlike branches of EC banks and investment firms, branches of EC insurance companies will continue to be authorized and regulated by the host state in accordance with provisions of EC directives, although the home state has responsibility for ensuring that the company meets overall solvency standards.

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[88] Second Council Directive of 22 June 1988 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 73/239/EEC (88/357/EEC) [hereinafter Second Non-life Insurance Directive], 31 <u>O.J. Eur. Comm</u>. (No. L 172) 1 (1988); Commission of the European Communities, "Proposal for a Second Council Directive on the coordination of laws, regulations and administrative provisions relating to direct life assurance, laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 79/267/EEC" [hereinafter Proposed Second Life Insurance Directive], COM(88) 729 final (December 23, 1988).

Moreover, also unlike the banking and investment services directives, the insurance directives adopted or proposed during 1988 distinguish among customers on the basis of the degree of protection that is deemed to be required.[89] The non-life insurance directive provides liberalization only for wholesale customers; specifically, cross-border provision of services under home-country control is permitted only for "large risks" (defined primarily in terms of the number of employees, sales, and assets). Similarly, the proposed life insurance directive provides liberalization only for individuals who take the initiative in seeking life insurance from a company in another state.[90]

Reciprocity. The proposed Second Banking Directive and the proposed Investment Services Directive contain reciprocity clauses, as does the proposed Second Life Insurance Directive.[91] (The Second Non-

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[89] Distinctions based on the degree of protection required by the customer were made by the European Court of Justice in judgments in four insurance cases in 1986. See infra pp. 52-55.

[90] Second Non-life Insurance Directive, art. 5; proposed Second Life Insurance Directive, art. 13, explanatory memorandum, p. 2. See also Commission of the European Communities "Proposal for a Council Directive amending, particularly as regards motor vehicle liability insurance, First Council Directive 73/239/EEC, and Second Council Directive 88/357/EEC on the Coordination of Laws, Regulations and Administrative Provisions relating to direct insurance other than life assurance and laying down provisions to facilitate the effective exercise of freedom to provide serivces and amending Directive 73/239/EEC" [hereinafter Proposed Motor Vehicle Liability Insurance Directive], art. 2.

The liberalizing provisions would apply to cross-border services provided both by head offices and by branches of EC insurance companies. Second Non-life insurance directive, arts. 2, 12; proposed Second Life Insurance Directive, arts. 2, 12.

[91] Proposed Second Banking Directive, art. 7; proposed Investment Services Directive, art. 6; proposed Second Life Insurance Directive, art. 9.

life Insurance Directive, which has already been enacted, does not contain a reciprocity clause, but the European Community reportedly plans to amend the directive to include one.) Under the EC reciprocity provisions, a non-EC financial firm would not be permitted to establish a subsidiary in <u>any</u> member state unless its home country granted reciprocal treatment to similar financial institutions from <u>all</u> member states. The meaning of the reciprocity clauses and the circumstances under which they might be applied have been the subject of considerable discussion both within the Community and abroad. The different concepts of reciprocity and their relationship to the approach of mutual recognition being used as the basis for integration within the Community are discussed in Section III.B below; more detailed explanations of the EC reciprocity proposals, including the revisions to the reciprocity proposal for banking services that were recently put forward by the Commission, are given in the appendices.

In brief, direct branches of non-EC financial institutions would not be subject to EC reciprocity requirements. Such branches would not benefit from the provisions of the directives permitting Community-wide expansion and would continue to be authorized and regulated separately by each host state.[92] Existing subsidiaries of non-EC financial institutions would be grandfathered and would be treated like any other financial institution in the member state in which they were

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[92] See <u>infra</u> Section III.B for a discussion of the treatment of direct branches of non-EC financial institutions, including proposals by the European Parliament for EC capital requirements for direct branches of non-EC banks.

chartered.[93] With regard to future entry through the subsidiary form of organization, in its April 1989 revisions to the reciprocity provision in the proposed Second Banking Directive, the Commission appears to distinguish between the criteria that could be used to limit or to bar entry to the EC market and the criteria that could be used as a goal in entering into negotiations with third countries.[94]

Under the revised proposal, prior to the effective date of the directive and periodically thereafter, the Commission would make a determination regarding the treatment of EC banks by third countries.[95] Only in a situation where a third country did not provide EC credit institutions with "national treatment and the same competitive opportunities as domestic credit institutions...and...[where] the condition of effective market access has not been secured," could the Commission take steps to delay or block a third country's banks from establishing subsidiaries within the Community.[96] An accompanying press

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[93] The explanatory memorandum accompanying the proposed Investment Services Directive states that "[a]s in the case of the banking Directive, the reciprocity regime does not apply to existing investment businesses already established in the Community." Proposed Investment Services Directive, explanatory memorandum, p. 5. See also _infra_ Appendix A.

[94] Commission of the European Communities "2nd Banking Directive--Revised Article 7 Reciprocity" [hereinafter Revised Reciprocity Proposal], Strasbourg, April 13, 1989. See also "Commission Clarifies Reciprocity Provisions in Proposed Second Banking Directive" [hereinafter April 13 Press Release], EC Press Release (Brussels, April 13, 1989).

[95] Revised Reciprocity Proposal, para. 3.

[96] _Id._, para. 5. The procedure under which the Commission could act is set forth in Article 20 of the proposed Second Banking Directive (see _infra_ Appendix A); as of this writing, it is not clear whether Article 20 will also be revised.

release states that entry for banks from "any country providing genuine national treatment to Community banks" would not be restricted.[97] In a separate clause, the revised proposal provides that if a third country does not grant EC banking institutions "effective market access and competitive opportunities comparable to those accorded by the Community," the Commission may submit proposals to the Council to enter into negotiations with third countries to try to achieve such access and opportunities.[98]

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[97] April 13 Press Release, p.2.

[98] Revised Reciprocity Proposal, para. 4. See infra Section III.B for a general discussion of the concepts of reciprocity and Appendix A for a more detailed discussion of their use in the Commission proposal.

III. CONCEPTUAL ANALYSIS OF THE EC PROGRAM FOR THE FINANCIAL SECTOR

A. Mutual Recognition: The EC Approach to Integration

The goal of the internal market program for the financial sector is to create a single, unified market by removing barriers to the provision of services across borders, to the establishment of branches or subsidiaries of EC financial institutions throughout the Community, and to transactions in securities on Community stock exchanges. In the financial sector, as in other areas, the Community has been faced with the need to determine the best method of achieving these goals. The question is what principles should be used to establish a regulatory, supervisory, and tax structure that would both facilitate the integration of Community financial markets and satisfy the public policy interests of the member states with regard to prudential rules, market stability, and monetary policy as well as consumer protection.

The starting point for the Community was the principle of non-discrimination, which in this context refers to the prohibition of discrimination between domestic and foreign residents based on nationality.[99] Although the right of establishment and the right to provide services in other member states without being subject to any restrictions based on nationality were set forth in the Treaty of

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[99] By contrast, in the context of trade and capital movements, "non-discrimination" usually refers to a prohibition of discrimination among foreign residents of different nationalities. That concept is similar to that of a most-favored nation clause, namely, benefits of any liberalization must be extended to all foreign countries on a nondiscriminatory basis.

Rome,[100] in both areas EC legislative action and decisions of the European Court of Justice have been necessary to give practical effect to these rights.

Non-discrimination by an EC member state amounts to offering national treatment to individuals and firms from other member states. Under a policy of national treatment, foreign firms are given the same opportunities for establishment and the same powers with respect to their host-country operations as their domestic counterparts; similarly, foreign firms operating in a host country are also subject to the same obligations as their domestic counterparts.[101] The purpose of a policy of national treatment is to promote competitive equality between domestic and foreign banking institutions by allowing them to compete on a "level playing field" within the host country.

It is not always possible to achieve exact equality of treatment, particularly if foreign and domestic banking structures differ significantly. For example, under U.S. law, with certain limited

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[100] Treaty of Rome, arts. 52, 59.

[101] The OECD's National Treatment Instrument defines national treatment as treatment under host-country "laws, regulations, and administrative practices...no less favorable than that accorded in like situations to domestic enterprises." OECD Declaration on International Investment and Multinational Enterprises, para. II.1 (June 21, 1976), 15 I.L.M. 967 (1976). See also Organisation for Economic Co-operation and Development, <u>National Treatment for Foreign-Controlled Enterprises</u> (Paris: OECD, 1985) for a comprehensive discussion of the National Treatment Instrument and its application in the OECD member countries. The expression "no less favorable" appears to allow for the possibility that exact national treatment cannot always be achieved and that any adjustments should be resolved in favor of the foreign firm; the wording is not meant to endorse an overall policy of "better than national treatment." See <u>infra</u> Section III.B.

exceptions, banking and commercial activities in the United States are clearly separated, while in many other countries commercial activities may be conducted by companies affiliated with banks. As a result, implementing the U.S. policy of national treatment has been particularly difficult with respect to direct investment in the United States by foreign banking organizations and their nonbanking affiliates.[102] Moreover, when foreign bank entry is through a branch rather than a subsidiary, domestic rules may need to be modified somewhat in order to apply them to branches in a reasonable manner, that is, in a way that takes into account the differing characteristics of branches, which are not separately incorporated entities.

If the European Community had adopted national treatment as an approach to financial integration, the result would have been a level playing field for foreign and domestic institutions within each national market. But, despite the fact that each country's rules would be applied on a nondiscriminatory (i.e., national treatment) basis, there still would have been twelve separate markets with different rules in each.

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102 In enacting the International Banking Act of 1978 (IBA), Congress did not want to apply U.S. law on an extraterritorial basis; neither, however, did it want to give U.S. operations of foreign banks or U.S. subsidiaries of foreign nonbanking affiliates of foreign banks an advantage over their domestic counterparts in the United States. The solution adopted in the IBA was to apply the nonbanking provisions of the U.S. Bank Holding Company Act (BHCA) to the U.S. operations of foreign banking organizations with U.S. offices, but to grandfather existing nonbanking affiliates and to provide foreign banks with a limited exemption from the BHCA rules regarding the separation of banking and commerce for certain commercial (but not financial) activities conducted in the United States by an affiliated foreign company. 12 U.S.C. §§ 1841(h), 3106(a),(c) (1982 & Supp. V 1987).

Moreover, although national treatment removes barriers to the provision of services by ensuring fair treatment for entry and operation within a country, it does not by itself address the question of the extent to which multinational cooperation or agreement is necessary to regulate and supervise financial activities conducted internationally or the question of the de facto barriers created by the lack of multinational harmonization of regulatory structures. The European Community's program represents an attempt to deal with these issues.

One approach, which, as noted above, was originally used by the Community with regard to products, would be to replace differing national laws and regulations with EC laws and regulations, which could then be enforced by the national authorities or, in the extreme case, by EC institutions. Within the Community, this approach is referred to as complete harmonization. As already noted, this approach was abandoned as involving too much detailed legislation at the Community level and totally impractical to achieve within any reasonable time horizon.[103]

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[103] In addition to the approaches of national treatment and complete harmonization, a hybrid model that the Community did not consider useful is provided by the U.S. dual banking system. The Community's program for banking services is designed to achieve a greater unification of the banking system than that which exists within the United States. In contrast to the structure being proposed for the Community, in the United States Federal law prohibits national banks and banks that are members of the Federal Reserve System from branching across state lines. 12 U.S.C. §§ 36, 321 (1982). Moreover, interstate establishment and acquisitions of banks are often governed by a policy of reciprocal national (i.e., state) treatment. (See infra Section III.B.) For example, an out-of-state bank may be permitted to establish or acquire a bank in a host state only if the host state's banks are permitted to establish or acquire banks in the out-of-state bank's home state. (Similar arrangements among groups of states within the United States are referred
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The Community's solution was to adopt the approach of mutual recognition. This approach requires each country to recognize the laws, regulations, and administrative practices of other member states as equivalent to its own and thereby precludes the use of differences in national rules to restrict access. The concept of mutual recognition is a powerful one in that it goes well beyond national treatment. In fact, under a policy of mutual recognition, as explained below, some member states are in effect agreeing to offer treatment that is more favorable than national treatment to firms from other member states.

Mutual recognition cannot simply be decreed among a group of countries with widely divergent legal systems, statutory provisions, and regulatory and supervisory practices. Mutual recognition of rules that differ with regard to what a country regards as essential elements and characteristics would be politically unacceptable. As a result, a crucial prerequisite for mutual recognition is harmonization of essential rules. Rules considered essential that are not in fact harmonized at the Community level may need to be excluded from the principle of mutual recognition.

In the financial sector, the process of harmonization involves identifying the rules that are essential for ensuring the safety and soundness of financial institutions and the rules that are essential for the protection of depositors, other consumers of financial services, and

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to as regional compacts.) However, despite this fragmentation of financial structure, the United States is a true monetary union.

investors. It is also necessary to determine how detailed the harmonization of these rules must be. For example, one question is whether it is enough to specify that the major shareholders of a financial institution must be determined to be "suitable" by home-country authorities or whether more specific criteria are needed.

Home-country control. A corollary of mutual recognition is home-country control. If national laws, regulations, and supervisory practices that have not been harmonized at the EC level are to be accorded mutual recognition, home-country rules and supervisory practices must be accepted as controlling the operations of branches and cross-border provision of services of financial institutions. However, the principle of home-country control adopted by the European Community is not absolute; in accordance with judgments of the European Court of Justice and EC directives, the host country retains the right to regulate branches or the cross-border provision of services to the extent that it is necessary to do so to protect the public interest.

In practice, the division of responsibility between home- and host-country regulators may be rather complicated. In general, the EC directives that have been proposed or adopted in the area of financial services provide for home-country control for initial authorization and for ongoing prudential supervision. However, various aspects of the day-to-day conduct of business could be subject to host-country control on a national treatment basis under, for example, consumer protection laws that had not been harmonized by the Community. In some directives, such host-country control is strictly limited or prohibited either because the extent of harmonization of investor protection rules at the EC level is considered sufficient (e.g., securities prospectuses and unit trusts) or because the wholesale customers covered by the directive are deemed not to require host-country protection (e.g., cross-border non-life insurance services). As a result, under the EC securities market directives, a company headquartered in Greece and listed on the Greek stock exchange could, for example, be listed on the London stock exchange under Greek rules that satisfied the EC minimum standards but provided prospective British investors with less information than a U.K. firm would be required to provide.

The European Court of Justice has already played a major role both in establishing a public interest test for host-country regulation and in determining whether that criterion has been met and will undoubtedly continue to do so in the future.[104] In the case of banking, the public interest of the host state would appear to be particularly strong because of the role of banks in the credit, monetary, and payments systems and because banks are within the so-called safety net of deposit insurance and lending of last resort by the monetary authorities. Rather than relying on the overall public interest exception to home-country control, the EC proposals include explicit exceptions for rules relating to the conduct of host-country monetary policy. In line with the Revised Basle Concordat, an exception to the principle of home-country control is

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[104] See <u>infra</u> pp. 52-55.

also provided for supervision of liquidity.[105] In practice, of course, questions are likely to arise as to whether particular restrictions are truly necessary for monetary policy purposes or whether particular regulations are addressed toward liquidity or solvency.

Provision of services through subsidiaries, branches and across borders. In analyses of issues relating to international trade in financial services, a distinction is usually made between the provision of services through establishment of subsidiaries and branches and the provision of services directly across borders. In general, more attention has been devoted to establishment issues, while cross-border provision of services has tended to be viewed within the context of removal of exchange controls. Recently, however, particularly within the Organisation for Economic Co-operation and Development, where much of the multinational work on trade in financial services has taken place, increased attention has been given to cross-border services that are not within the scope of the liberalization of capital movements, for example,

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[105] The original 1975 Basle Concordat, which represented an agreement reached by the bank regulatory authorities of twelve major industrial countries (see supra note 75), set forth principles regarding the relative roles of home- and host-country supervisors in an effort to ensure that all banking organizations operating in international markets were supervised institutions. The Revised Concordat, which was released in 1983, incorporates the principle of supervision of multinational banking institutions on a consolidated worldwide basis. See BIS Committee on Banking Regulations and Supervisory Practices, "Revised Basle Concordat on Principles for the Supervision of Banks' Foreign Establishments" [hereinafter Revised Basle Concordat] 22 I.L.M. 901 (1983) and infra Appendix A.

asset management and investment advice.[106]

The conceptual grouping of services into those provided through establishment of subsidiaries and branches and those provided across borders is not of critical importance when both are being discussed in the context of a policy of national treatment. However, within the European Community, where the overall approach to intra-Community trade in services is mutual recognition, the conceptual grouping does matter. In directives in the areas of banking and investment services proposed during 1988, the EC Commission has in effect drawn a line between services provided through subsidiaries and services provided through branches or across borders.[107]

Under the EC program for financial integration, subsidiaries of financial firms headquartered in other member states will continue to be governed by the principle of national treatment. (The right of a bank from one member state either to establish or to acquire a bank in another member state is, at least in theory, guaranteed by the Treaty of Rome.[108]) As a result, such subsidiaries are treated in the same manner as other incorporated entities in the host state. For example, a German

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[106] See generally, OECD, International Trade in Services: Securities (Paris: OECD, 1987); International Trade in Services: Banking (Paris: OECD, 1984); International Trade in Services: Insurance (Paris: OECD, 1984).

[107] By contrast, in the insurance sector, the EC directives retain the more conventional line between services provided through branches and subsidiaries and those provided across borders. See *infra* Section III.B and Appendix D.

[108] See *infra* Appendix A.

banking subsidiary of a U.K. bank could branch throughout the Community under German rules with respect to permissible activities.

By contrast, the EC approach to provision of services through branches and across borders is quite different. Mutual recognition and home-country control are made possible through the harmonization of basic rules applicable to the parent banking or investment firm. Such harmonization includes, for example, general criteria for home-country authorization and supervision, establishment of minimum capital requirements for banks and investment firms, and for banks, agreement on a list of activities considered integral to banking.

Under a regime of mutual recognition and home-country control, the powers of, for example, a Greek branch of a U.K. bank would be determined by U.K. rules in accordance with the list specified by the Community, not by Greek rules. Similarly, Greek branches of banks from other EC countries would be governed by their respective home-country rules. As a result, a branch of a bank from another member state could receive treatment that is better than national treatment from Greece. Alternatively, if the bank's home country had rules with respect to bank powers that were more restrictive than those of Greece, the bank's Greek branch could receive treatment that is worse than national treatment in Greece.[109]

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[109] In theory, a Greek bank (or a bank from any EC country) could establish a subsidiary bank in London and the London subsidiary could branch into Greece under home-country (i.e., U.K.) control. In other words, the Greek branch of the London subsidiary of a Greek bank would have broader powers to conduct activities in Greece than would its parent
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Regulatory convergence. The result of the EC approach, at least in the short run, could be competitive inequalities and fragmentation of markets. However, with regard to the financial services sector, the European Community assumes that over the longer run market forces will create pressure on governments that will lead to convergence of additional national rules and practices that have not been harmonized at the EC level. Pressures for regulatory convergence within the Community would arise both from the absence of restrictions on capital movements and from the regulatory advantages enjoyed by branches of banks and investment firms from other member states and also by the head offices of such banks and investment firms in providing services across borders.

In the financial sector the principle of mutual recognition is thus being used by the Community as a pragmatic tool that, in combination with market forces, is expected to result in a more unified, less restrictive regulatory structure. The process is an interactive one: mutual recognition requires initial harmonization, but additional harmonization requires mutual recognition. In adopting the approach of mutual recognition in the financial area, the Community is in effect using trade in financial services as a lever to arbitrage the regulatory policies of the member states.

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bank. Some EC officials assert that in practice this situation would not arise because prior consultation among the supervisory authorities regarding the establishment of subsidiaries would prevent such byzantine organizational structures. In any event, the potential for such structures could lead to increased pressure for regulatory convergence.

Regulatory convergence is particularly likely to occur with regard to bank powers because the Community has reached a theoretical consensus on what activities are permissible for banks. In effect, a goal for regulatory convergence has been agreed upon by the member states. Banks permitted by their home country to engage in any of the activities listed in the proposed Second Banking Directive are specifically permitted to engage in such activities anywhere in the Community through a branch or through cross-border provision of services.[110] As a result, although the European Community has not required governments to give their banks the powers on the list, a situation has been created where regulatory convergence toward the EC list of activities as a result of market forces seems almost inevitable.[111] Other areas, particularly if the model for convergence has not been specified in advance, could be more complicated.

A possible example of the absence of agreement on a goal for regulatory convergence, namely, that credit institutions should be permitted to become members of stock exchanges, may explain a notable exception to the principle of mutual recognition in the EC proposals for

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[110] See <u>infra</u> Appendix A regarding activities not on the EC list.

[111] Although some member states require certain securities activities to be conducted in a subsidiary of a bank, such subsidiaries are often funded by the bank. By contrast, so-called Section 20 subsidiaries of bank holding companies in the United States (which were recently authorized by the Federal Reserve Board to engage in underwriting and dealing in debt and equity securities) may not be funded by the bank; subject to the approval of the Board, such subsidiaries may be funded by the bank holding company. <u>J.P. Morgan & Co. Incorporated et al.</u>, 75 <u>Federal Reserve Bulletin</u> 192 (March 1989).

the financial sector. Under the Commission's proposals, in accordance with the principle of mutual recognition, a host state must ensure that a branch of an investment firm that is a stock exchange member in its home state is permitted to become a member of the host country's stock exchange.[112] By contrast, a branch of a credit institution, even if the credit institution is a member of a stock exchange in its home country, is governed by a policy of national treatment. As a result, if a host member state does not allow its own credit institutions to be members of its stock exchange, it is not obligated to admit a branch of a credit institution chartered in another member state.[113] Such a credit institution could gain access to the host-country exchange only through a subsidiary investment firm or through a branch of such a firm.

Competitive pressures associated with cross-border provision of services, in combination with the absence of restrictions on capital movements, might also over time contribute to some convergence of regulations that remain exclusively under <u>host</u>-country control. One likely area of convergence is elimination of any remaining interest rate ceilings, although the primary factor may be the ongoing process of deregulation in this area, including the development of alternative instruments.[114] Possible, but less likely, is some move toward

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[112] Proposed Investment Services Directive, art. 10. See also <u>infra</u> Appendix B.

[113] Proposed Investment Services Directive, art. 10.

[114] For example, in France payment of interest on demand deposits is prohibited, but interest may be paid on such deposits in most of the other EC countries. (EC officials consider such interest rate
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convergence of the effective tax imposed by reserve requirements, that is, the level of such requirements and the extent, if any, to which interest is paid on reserve balances. However, other factors such as differences in corporate taxation among the member states would also affect the relative tax treatment of banks.[115]

In addition to market pressures for a liberalizing regulatory convergence with regard to rules such as those relating to bank powers, market pressures could also lead to competition in laxity among supervisory authorities. Such competition could occur either with regard to standards that have not been harmonized or have been harmonized only in general terms, or with regard to enforcement of agreed upon standards. Moreover, market pressures could prevent governments from imposing or maintaining standards stricter than the minimums set forth in the

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limitations within the scope of monetary policy and thus subject to host-country control.)

115 See supra Section II.A regarding withholding taxes. Proposals to harmonize corporate tax structures (but not rates) were put forward in the 1970s but never acted upon. See Commission of the European Communities, "Proposal for a Council Directive concerning the harmonization of systems of company taxation and of withholding taxes on dividends," 18 O.J. Eur. Comm. (No. C 253) 2 (1975). In the memorandum accompanying its 1989 proposals for a common withholding tax, the Commission suggested that the proposal for harmonization of corporate tax structures be activated and that consideration also be given to harmonization of corporate tax rates. Communication Regarding Withholding Taxes, para. 5. However, although corporate tax structures and rates differ within the Community, during the past few years some of the member states lowered their corporate tax rates within a relatively short period of time, which suggests that market pressures may act as a constraint on the extent to which effective tax rates will be allowed to diverge.

directives, even though they are usually permitted to do so. The EC view is that no major problems will arise with regard to competition in laxity because the scope of harmonization is sufficiently broad and because the minimum standards that have been adopted by the Community are sufficiently high.

Problems would also be less likely to arise the greater the theoretical agreement among the member states as to the line between liberalization and laxity, that is, the distinction between national rules that have primarily the effect of imposing barriers to trade in services and national rules that are necessary for prudential or consumer protection purposes. For example, there is a consensus within the Community that permitting all forms of securities activities to be conducted at a bank or its subsidiary is a positive, liberalizing measure; not all within the United States would share this view.

A different possibility is that the market might place a value on national standards that were more stringent than those required by EC directives. While governments are obligated to accord mutual recognition to differing national standards that have not been harmonized, private firms and individuals are, of course, under no such obligation. Indeed, in a more competitive marketplace, firms and individuals may have even greater scope to exercise their preferences. For example, a U.K. bank or securities firm might be considered by customers to be preferable to an institution authorized and supervised by authorities of another member state even though such institutions might offer a price advantage.

The financial sector may be particularly suited to the interactive process of mutual recognition and harmonization of regulatory frameworks. One reason, already noted, is the existence, apart from the EC program, of an ongoing process of internationalization of financial services and markets. This process has already resulted in cooperation among the major industrial countries with regard to bank supervision and agreement on basic harmonization of national regulations with regard to bank capital. Thus market pressures for regulatory convergence in the banking sector exist well beyond the borders of the Community.

Another reason why the financial sector may be particularly suited to an interactive process of basic harmonization and mutual recognition is that rules are applied primarily to producers of financial services in contrast to the product sector where standards apply to the products themselves. In part because of the intangible nature of the service being provided, the financial sector can adapt very quickly to changes in the regulatory or market environment. Technological developments can be rapidly assimilated and innovation in the form of new instruments or practices can occur with considerable speed. This situation is in marked contrast to the product area where long periods of research and development might be necessary or where even a simple change in standards could require a lengthy implementation period.

As a result, in the financial sector it would appear easier to use the approach of harmonizing some basic standards and letting market forces produce additional harmonization. If market forces do not produce further harmonization _and_ there is a consensus among the member states that such harmonization is necessary, it can probably be accomplished at a later stage without major dislocations. (An example is the Commission's approach to deposit insurance programs.[116]) However, because of the substantial public policy interests involving macro-economic policy, prudential regulation, and stability of markets that are inherent in the financial sector in addition to consumer protection, it may also be true that, compared with non-financial services, a greater degree of initial harmonization is required to make mutual recognition and home-country control acceptable. In any event, after implementation of the EC program for basic harmonization of the framework for financial services, remaining differences in national rules that create significant barriers could be removed not only as a result of market pressures or by additional harmonization, but also as a result of actions brought before the European Court of Justice.

Judgments of the European Court of Justice. In 1986, the European Court of Justice addressed some of the issues relating to the use of the principle of mutual recognition for financial integration within the Community in four insurance cases. The Court's judgments provided guidance as to the degree of harmonization of essential elements it considered necessary for mutual recognition and home-country control in the insurance sector and what test should be used to determine the

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116 See _infra_ Appendix A.

legality of host-country restrictions on cross-border provision of services.

The Court dealt with the issue of the extent to which a member state is permitted to impose authorization and other requirements on an insurance company based in another member state that wishes to offer cross-border services.[117] The Court found that "the insurance sector is a particularly sensitive area from the point of view of the protection of the consumer both as a policy-holder and as an insured person."[118] As a result, the Court said, in the field of insurance there exist "imperative reasons relating to the public interest" that may justify restrictions on the freedom to provide services.[119] The Court emphasized that such restrictions must be applied equally to foreign and domestic firms (i.e., on a national treatment basis) and that the restrictions could not be justified if the public interest was already protected by the rules of

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[117] Re Insurance Services: EC Commission v. Germany (Case 205/84), [1987] CMLR 69; Re Co-insurance Services: EC Commission v. France (Case 220/83), [1987] CMLR 113; Re Co-insurance Services: EC Commission v. Ireland (Case 206/84), [1987] CMLR 150; Re Insurance Services: EC Commission v. Denmark (Case 252/83), [1987] CMLR 169.

The cases also presented the issue of whether a host country could in effect ban the provision of cross-border services in insurance by requiring a company to have a permanent establishment in the host state. The Court held that "the requirement of a permanent establishment is the very negation of [the freedom to provide services]" and would require justification as an "indispensable requirement," a justification the Court found not to exist in this case. EC Commission v. Germany, [1987] CMLR at 107-08.

[118] EC Commission v. Germany, [1987] CMLR at 101-02.

[119] The term used by the Court (French is the working language) is "interêt général." In the English translation, the terms "the general good" and "the public interest" are used interchangeably. Id.

the home state or if the same result could be achieved by less restrictive rules.

In examining the extent to which the public interest justified restrictions on the cross-border provision of insurance services, the Court distinguished between types of customers on the basis of the degree of protection deemed to be needed. For small policyholders, the Court determined that existing Community legislation did not provide sufficient harmonization to justify a claim that the public interest was already protected by the home state. Moreover, the Court found that the requirements imposed by the host state were not excessive. However, with regard to authorization and other requirements for coinsurance of large, commercial risks that were at issue in two of the cases, the Court found that such restrictions could not be justified because such policyholders did not require the same degree of protection as did the smaller policyholders.[120]

The insurance decisions confirmed that the principle of mutual recognition and the obligations of the member states not to erect barriers that had been established in Cassis de Dijon extended to services as well as to goods. The judgments also established the public interest test and a methodology for applying it in order to determine the legality of any barriers to the provision of services across borders. In

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[120] Id. at 110. EC Commission v. Ireland, [1987] CMLR at 166. EC Commission v. France, [1987] CMLR at 126. In the co-insurance cases, the Court also struck down requirements that the leading insurer have an establishment in the host state. EC Commission v. Ireland, [1987] CMLR at 164-67; EC Commission v. France, [1987] CMLR at 145-46.

its proposed banking and investment services directives, the EC Commission has in effect extended the Court's public interest test to apply also to host-country restrictions on services provided through branches.[121] This extension is a logical consequence of the conceptual grouping of these two forms of provision of services discussed above. The Court's decisions have been generally interpreted to mean that a member state may continue to apply its own rules on a national treatment basis only if the rules can be justified by the public interest test and Community legislation has not already provided harmonization of basic rules in the relevant areas.[122]

Supranational structure of the Community. In considering the use of mutual recognition as the approach to financial integration within the Community and its relevance in contexts beyond the Community, it should be remembered that the member states have agreed to use mutual recognition as the tool to achieve an integrated market in the context of a structure that, while not a federation, is a rather powerful supranational structure to which the member states have already transferred a significant degree of sovereignty.[123] While the customs

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[121] The directives specifically refer to the public interest criterion for host-country rules in both situations. Proposed Second Banking Directive, preamble, arts. 17, 19; proposed Investment Services Directive, preamble, arts. 11, 13.

[122] See, e.g., British Bankers' Association, "The Second Banking Directive: A Commentary," March 1988, p. 56.

[123] See N.V. Algemene Transport- en Expeditie Onderneming van Gend en Loos v. Nederlandse Administratie der Belastingen (Case 26/62), [1963] ECR 1, [1963] CMLR 105. See also Costa v. Ente Nazionale per l'Energia Elettrica (ENEL) (Case 6/64), [1964] ECR 585, [1964] CMLR 425.

union with its common external commercial policy is the basis of the internal market, the internal market is much more than a customs union. It involves a supranational legislative process under which supranational rules ensuring free movement of goods, persons, services, and capital are adopted and harmonization of basic laws, regulations, and practices at a supranational level can be achieved. Moreover, there is the very real possibility that a member state will have to adopt and enforce measures that it opposed in the Community legislative process. Community law is accepted as prevailing over national law,[124] and both judgments and preliminary rulings of the European Court of Justice based on Community law are binding and enforceable in the member states.[125]

The Community is also more than a single, unified market. Other aspects of the Community addressed by either the original Treaty of Rome or by the Single European Act include social policy, economic and social cohesion, research and development, the environment, and the issue of economic and monetary union.[126] The Single European Act also refers to the goal of a "European Union,"[127] although there is considerable

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[124] The principle of supremacy of Community law was not explicitly stated in the Treaty of Rome but has been confirmed by the European Court of Justice in judgments interpreting provisions of the Treaty. See Costa v. Ente Nazionale per l'Energia Elettrica (ENEL) (Case 6/64), [1964] ECR 585, [1964] CMLR 425. See also Internationale Handelgesellschaft mbH v. Einfuhr- und Vorratsstelle für Getreide und Futtermittel (Case 11/70) [1970] ECR 1125, [1972] CMLR 255; J. Nold, Kohlen- und Baustoffgrosshandlung v. Commission of the European Communtities (Case 4/73) [1974] ECR 491, [1974] CMLR 338.

[125] See Treaty of Rome, arts. 187, 192.

[126] See supra Section I.B.

[127] Single European Act, preamble. See also id., art. 1.

disagreement within the Community as to what such a union would entail.[128]

These institutional and political characteristics of the European Community are relevant to the question of the extent to which the approach used by the Community for financial integration is applicable to attempts to remove barriers and achieve a more integrated structure for financial services and markets on a more global basis. A basic question involves the degree of multinational harmonization that would be required and the extent, if any, that sovereignty would need to be surrendered to apply the principle of mutual recognition more broadly among nations.

The radical difference between what the Community is trying to achieve and other types of economic arrangements between nations is illustrated by a comparison with the U.S.-Canada Free Trade Agreement (FTA).[129] Unlike a customs union, the FTA does not even have a common external tariff or commercial policy and its goals are limited to eliminating bilateral tariffs, reducing many non-tariff barriers, liberalizing investment practices, and providing ground rules for trade in services, which in the financial sector consist of the principle of

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[128] See Jacques Delors, President of the European Commission, Statement before the European Parliament regarding the Council meeting in Hanover, June 7, 1988, 31 O.J. Eur. Comm. (Annex, No. 2-367) 137 (1988), and "The Main Lines of Commission Policy," Statement before the European Parliament, Strasbourg, January 17, 1989. But see also Margaret Thatcher, Prime Minister of the United Kingdom, Speech before the College of Europe, Bruges, September 20, 1988.

[129] United States-Canada Free Trade Agreement, 27 I.L.M. 281 (1988).

national treatment.[130] There is no commitment to a single unified market. A limited dispute-settling mechanism (from which financial services are excluded) is set up that does not involve a sacrifice of national sovereignty, and there are no supranational legislative or judicial functions.

The question of what approach is most useful for trade in financial services among nations is also raised by the EC proposals for treatment of third-country institutions. The relevance of the internal EC approach of mutual recognition both to the EC proposals for third-country access and to a more global integration of financial structures is discussed in the following section.

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130 Id. See also United States-Canada Free Trade Agreement: Communication from the President of the United States, House Doc. 100-216, 100th Cong., 2d Sess. (Washington: U.S. Government Printing Office, 1988).

B. <u>The External Dimension: Approaches to Access for Third-Country Firms</u>

The 1985 White Paper did not address the external dimension of the program to complete the internal market, and EC policy with regard to third-country firms is being developed in the context of individual directives. The directives that were proposed by the Commission in 1988 in the area of financial services--banking, investment services, and insurance--all contain provisions that would establish a Community-wide policy of reciprocity.[131] As discussed below, certain aspects of the EC position on reciprocity could be viewed as the equivalent of an attempt to extend the principle of mutual recognition beyond the borders of the Community without first achieving the necessary harmonization or agreement on goals for regulatory convergence.

<u>Reciprocal national treatment</u>. Reciprocity is typically defined as either reciprocal national treatment or as mirror-image reciprocity. Under a policy of reciprocal national treatment, the Community would offer national treatment to a non-EC bank provided that its non-EC home country offered national treatment to banks from all EC countries. National treatment in the non-EC home country could be evaluated on the basis of entry alone, or it could be evaluated with respect to operations of established institutions. Under a policy of reciprocal national treatment, if the national treatment criteria were not fulfilled by the

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131 See <u>supra</u> Section II.B for an overview and <u>infra</u> Appendices A-D for details.

home country, the non-EC bank could be denied entry.[132]

Mirror-image reciprocity. A policy of mirror-image reciprocity would involve an attempt to achieve a precise balancing of the treatment that is accorded EC and non-EC banks in each other's markets. The criteria for such mirror-image treatment could be based either on specific conditions for entry in the non-EC home country or on the home country's rules with regard to operations, or both. For example, if a non-EC country permitted entry by EC and other foreign banks only in the form of branches, not subsidiaries, the European Community might refuse to allow banks from that country to enter the Community through the subsidiary form of organization. Suppose that a non-EC country, in accordance with its own policy of national treatment, did not permit EC or other foreign banks to engage in securities activities. Under a policy of mirror-image reciprocity, the European Community might either deny entry to banks from the non-EC country or permit the banks to enter the Community but prohibit them from engaging in securities activities.

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[132] Reciprocal national treatment has also been used with regard to certain operations within a market in a host country. For example, in an exception to the overall U.S. policy of national treatment, a provision of the 1988 trade legislation imposes a policy of reciprocal national treatment with regard to operating as a primary dealer in the government securities market. Specifically, a foreign company operating in the United States may not be designated as a primary dealer unless the firm's home country offers U.S. firms the same competitive opportunities to underwrite and distribute government debt instruments issued by that country as are accorded to its domestic firms, i.e., unless the home country offers national treatment to U.S. firms. Omnibus Trade and Competitiveness Act of 1988, §§ 3501-02, 22 U.S.C.A. §§ 5341-42 (West Supp. 1989).

Better than national treatment. In addition to these two concepts of reciprocity, there is a third concept involving a better than national treatment approach that has arisen in the context of some international discussions. Under this approach, the Community would seek to have a non-EC country offer EC banks treatment comparable to that accorded banks within the Community. For example, the Community might suggest that EC banks with U.S. banking operations should, unlike U.S. banks, be allowed to conduct securities activities in the United States without regard to the limitations imposed on domestic banks by U.S. law. One way of viewing the better than national treatment approach is as a "liberal" version of mirror-image reciprocity. Mirror-image reciprocity is typically thought of in terms of restricting country X's banks in country Y to what country Y's banks can do in country X, even though such restrictive treatment is usually imposed by country Y with the ultimate goal of achieving liberalization in country X. A request by country Y for better than national treatment in country X simply skips (or uses as a threat in reserve) the restrictive step and goes directly toward the liberalization in country X.

But a request for better than national treatment by the European Community would involve more than a banking services reciprocity concept. In effect, it would be the equivalent of an attempt to extend the principle of mutual recognition, which is the basis for the EC internal market program, to countries outside the Community. Because of the importance and acceptance of the principle of mutual recognition as the approach for integration within the Community, it might, on the surface, seem logical for the the treatment of third-country firms by the Community to be based on this principle.

However, the foundation for mutual recognition that exists within the Community, namely, the negotiated harmonization of essential laws and regulations (including the agreed upon list of universal banking powers toward which it is expected each member state's own structure will converge), does not exist on a more global level.[133] As a result, if the European Community were to use the principle of mutual recognition as the basis for its policy toward non-EC firms, such a policy could be viewed as an attempt by the Community to impose its internally negotiated harmonization upon other major industrial countries. In contrast to the situation within the Community, only harmonization of bank capital standards and the principle of consolidated supervision for banking organizations have been negotiated at a more global level; there has not been any attempt to achieve similar multilateral accords with regard to investment services or insurance or with respect to bank powers.

An EC request for better than national treatment would also involve a divergence between permissible powers of foreign and domestic banks in other countries such as the United States. As discussed above, the European Community appears to be prepared to accept such competitive inequality (involving treatment both better and worse than national treatment) <u>within</u> the Community during what is assumed will be a short-run transitional period. Such inequality is, however, based on a

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[133] Within the United States, such agreement does not even exist among the states or between the Federal government and the states.

negotiated set of rules among its members, and convergence toward a common set of rules is viewed as the desired outcome. In a more global context, other nations could not be reasonably expected to have such rules imposed upon them without participating in the negotiations and without explicit acceptance of a goal of convergence.[134]

Direct branches of non-EC financial institutions. The better than national treatment approach also highlights the differences in proposed treatment of direct branches and of subsidiaries of non-EC banks and investment firms by the European Community. Direct branches of non-EC banks and investment firms would not be subject to EC reciprocity requirements, and such branches would not benefit from the provisions for Community-wide expansion in the directives. Direct branches would continue to be licensed separately by each host state and would be subject to host-country regulatory and supervisory requirements.[135] In

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[134] Moreover, a relationship between a non-EC country and the Community based on mutual recognition of differences in laws and regulations would need to be symmetrical. In theory, in some instances, the Community countries might need to provide better than national treatment for non-EC institutions.

[135] A report (first reading) of the European Parliament on the Second Banking Directive suggests applying EC initial capital and solvency ratio requirements to direct branches of non-EC banks. European Parliament, Minutes of the proceedings of the sitting of Wednesday, 15 March 1989 (provisional ed.), pp. 33-36. However, the Commission has indicated its disagreement with these proposals. Sir Leon Brittan, Vice-President of the Commission, Statement before the European Parliament, Verbatim report of proceedings, Monday, 13 March 1989 (provisional ed.), pp. 26-27.

EC rules similar to those proposed by the Parliament for direct branches of non-EC banks have already been established by the Community for direct branches of non-EC insurance firms. See infra pp. 65-66. Like the insurance directives, the Parliamentary proposals for direct branches of non-EC banks do not contain a reciprocity provision for the

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the EC countries that already have a policy of national treatment for such branches, such a policy would presumably remain in effect.[136] However, it is always possible that individual countries could delay or impede branch applications to obtain concessions from the bank's home country.

Thus in theory direct branches of non-EC banks or investment firms would be an issue for the Community only if there were to be more global mutual recognition, that is, if the European Community were to permit a non-EC bank or investment firm to branch directly anywhere in the Community under non-EC home-country control.[137] Obviously, the

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establishment of such branches. However, also like the insurance directives, the Parliamentary suggestions for the banking directive provide that capital and other requirements for direct branches different (i.e., less burdensome) than those in the directive could be negotiated with third countries on a reciprocal basis. See _infra_ pp. 66-67 regarding the negotiation of such an agreement between Switzerland and the Community for direct branches of insurance companies.

136 The EC's First Banking Directive contains a clause prohibiting a member state from granting branches of non-EC banks treatment more favorable than that granted to banks from other member states. Another clause authorizes negotiation of agreements with third countries that would grant branches from a third country identical treatment throughout the Community on the basis of reciprocity. First Council Directive of 12 December 1977 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions [hereinafter First Banking Directive], art. 9, 20 _O.J. Eur. Comm_. (No. L 322) 30 (1977).

137 There is an element of recognition, which could be either unilateral or mutual, on the part of a host country whenever it permits entry by direct branches of a foreign bank. Permitting branch entry _per se_ implies some recognition of the competence of home-country authorization and supervision. Moreover, some countries such as the United Kingdom do
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European Community is not prepared to do this. Moreover, if carried to its logical conclusion, an attempt to apply the principle of mutual recognition on a more global level could imply that direct EC branches of non-EC banks and investment firms should, like branches of similar firms within the Community, have their powers limited by their home country. In the case of U.S. banks, this would become quite circular, since the United States determines the powers permitted to foreign branches of U.S. banks at least in part on the basis of what is permitted in the host country.

The EC treatment of direct branches of non-EC insurance companies differs from that of direct branches of non-EC banks and investment firms. For direct branches of non-EC insurance firms, solvency and other requirements established by EC directives must be met for host-country authorization and regulation.[138] These requirements are

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not impose any endowment capital requirement on branches of foreign banks. Recently, under provisions of the Financial Services Act, the U.K. authorities have entered into a series of "understandings" with regulatory authorities in other major industrial countries that could be viewed as the equivalent of unilateral recognition of home-country capital requirements for branches of firms conducting an investment business (as defined by the Act) in the United Kingdom. Under these arrangements, such branches are exempt from U.K. capital requirements subject to the provision of certain information by home-country regulators to U.K. authorities. See, e.g., Memorandum of Understanding among the U.S. Securities and Exchange Commission, the self-regulatory organizations in the United States and in the United Kingdom, and the Bank of England, August 17, 1988.

[138] First Council Directive of 24 July 1973 on the coordination of laws, Regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance
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more burdensome than those applicable to branches of EC insurance companies. However, the insurance directives also include provisions that would permit the Community to negotiate with third countries, on a reciprocal basis, requirements different from those in the directive.[139]

Under this provision, the Community has been negotiating an agreement with Switzerland whereby Swiss non-life insurance companies could establish direct branches in any member state on the same terms as insurance companies from other member states.[140] Similarly, EC companies would be allowed to establish direct branches in Switzerland on the same terms as Swiss companies. However, the basis of this agreement is a commitment by Switzerland to conform its insurance legislation, primarily

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(73/239/EEC) [hereinafter First Non-life Insurance Directive], arts. 23-28, 16 O.J. Eur. Comm. (No. L 228) 3 (1973); Council Directive of 24 July 1973 abolishing restrictions on freedom of establishment in the business of direct insurance other than life assurance (73/240/EEC), 16 O.J. Eur. Comm. (No. L 228) 20 (1973); First Council Directive of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance (79/267/EEC) [hereinafter First Life Insurance Directive], arts. 27-31, 22 O.J. Eur. Comm. (No. L 63) 1 (1979).

139 First Non-life Insurance Directive, art. 29; First Life Insurance Directive, art. 32.

140 As is the case for branches of EC insurance companies, a host member state authorizing a direct branch of a Swiss insurance company would rely on the home-country authorities for verification of the company's overall solvency; direct branches of Swiss insurance companies would no longer be subject to a separate EC solvency margin requirement. See Commission of the European Communities, "Proposal for a Council Decision on the conclusion of the Agreement between the Swiss Confederation and the European Economic Community on direct insurance other than life assurance," 26 O.J. Eur. Comm. (No. C 154) 33 (1983). See also William Dawkins, "Swiss agree insurance deal with EC," Financial Times, November 19, 1988, p. 3.

with regard to solvency requirements, to the standards set forth in Community directives. In this instance, therefore, the harmonization of basic standards, as determined by the Community, has permitted the principle of mutual recognition to be extended beyond the borders of the Community. However, the scope of the agreement is somewhat limited, and as a result, direct branches of Swiss insurance companies would not benefit from the liberalizing provisions of the Second Non-life Insurance Directive with regard to cross-border services.

Effective market access. In the context of the mid-term review of the Uruguay Round of GATT negotiations held in Montreal in December 1988, yet another concept related to host-country treatment of foreign financial institutions has emerged, namely, effective market access.[141] Effective market access (which the European Community sometimes refers to as the "broad definition of national treatment") appears to encompass two different concepts: national treatment and "progressive liberalization"[142] of laws and regulations relating to banking and other financial services. In other words, national treatment in the context of a restrictive, highly regulated banking system might not be considered to provide effective market access. The concept of effective market access appears to be based on the arguments that (a) a highly regulated host-country environment may have a differential impact on foreign and domestic institutions and (b) host-country treatment may be so

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141 See Statement by Trade Ministers of the Trade Negotiations Committee of the GATT Uruguay Round (Montreal, December 8, 1988), p. 2.

142 Id.

restrictive in comparison with the regulatory framework for banking services in other industrial countries, that a market distortion is created.

The first argument implies that in a highly regulated environment it is much more difficult to achieve national treatment for foreign banking organizations than it is to achieve such treatment in a more open system. But it does not necessarily follow that is impossible to achieve national treatment under such circumstances. If, however, it is assumed that national treatment cannot be defined or achieved in a restrictive environment, liberalization of the regulatory structure is necessary to achieve meaningful access to domestic markets.

The second argument, because it is based on a more global comparison of regulatory structures, raises the issue of harmonization once again. At least for the industrial countries, "progressive liberalization" could be viewed as a somewhat less formal and less structured GATT equivalent of one aspect of the EC process of harmonization of essential laws, regulations, and practices. (The concept of progressive liberalization does not, however, include the critical aspect of the EC process of harmonization that is designed to establish minimum prudential standards stringent enough to ensure safety and soundness.) Because the degree of liberalization is measured against that existing in other major industrial countries, trying to achieve progressive liberalization in countries with restrictive structures amounts to an attempt to bring those structures into rough conformity with the more liberal structures in other countries.

Of course, if such harmonization of regulatory structures were to occur among the industrial countries, whether through discussions conducted under the auspices of the Uruguay Round, the Organisation for Economic Co-operation and Development, or the Bank for International Settlements, it would provide a basis for applying the EC principles of mutual recognition and home-country control more widely. Ultimately, as is expected to happen within the Community, there could be additional convergence of bank regulatory structures among the industrial countries. In a world of complete convergence, the policies of national treatment, reciprocal national treatment, mirror-image reciprocity, and effective market access would produce identical results. Pending such convergence, however, the differences among these concepts are still important. And some of the most difficult problems are presented by the lack of agreement among the major industrial countries regarding the permissible activities of banks, in particular, whether to separate commercial and investment banking.

Disadvantages of reciprocity. One motivation for the introduction of the EC reciprocity provisions may have been to strengthen the EC's bargaining position in bilateral or multilateral negotiations.[143] However, because of the highly uncertain outcome, a strategy based on the use of reciprocity as a bargaining tool could be very risky. If a reciprocity policy is in fact used to bar entry by some foreign financial institutions, the ultimate effect of the policy could

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[143] See, e.g., Sir Leon Brittan, Statement before the European Parliament, supra note 135, p. 26.

be to close rather than to open markets. Moreover, if any reciprocity policy is adopted and a review procedure is set up, a bureaucratic structure will have been created that, once in place, has the potential for being used in an increasingly restrictive manner.

An EC reciprocity policy, depending on its definition and implementation, could result in a complex regulatory structure for operations of banks from different countries outside the Community. Such a structure could involve discrimination not only between foreign and EC-owned financial institutions but also among foreign financial institutions from different countries. Moreover, a reciprocity review procedure could delay applications by non-EC banks to establish or acquire banks within the Community. Such delays could be particularly burdensome if reciprocity were to be determined on a case-by-case basis rather than by an established rule for each non-EC country.

Adoption of a reciprocity policy by the European Community could undermine efforts supported by the United States in various international fora to achieve national treatment for foreign financial institutions in a host country. Moreover, such a policy might be inconsistent with the OECD Code of Liberalisation of Capital Movements, the OECD Code of Liberalisation of Current Invisible Operations, and the OECD National Treatment Instrument.[144] U.S. Treasury and Federal Reserve

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[144] In general, the OECD Codes of Liberalisation cover initial entry and the National Treatment Instrument applies to treatment after entry. See OECD Code of Liberalisation of Capital Movements (Paris: OECD, 1988); OECD Code of Liberalisation of Current Invisible Operations (Paris: OECD, 1988). See generally Introduction to the OECD Codes of Liberalisation
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officials had expressed serious concerns regarding the initial EC reciprocity proposals and urged that the Community adopt a policy of national treatment, which, in general, is the U.S. policy toward foreign banks and other foreign direct investment in the United States.[145] The overall U.S. policy of national treatment, which applies without regard to home-country treatment of U.S. banks, is based on the belief that open and competitive markets facilitate a more efficient, a more innovative and dynamic, and a more financially sound banking system.

Use of a financial services reciprocity concept as a bargaining tool in the general context of trade negotiations could also create problems because of differences between trade in financial services and trade in other services and goods. As has been emphasized above, financial services involve issues of prudential regulation, monetary policy, and stability of financial markets. Thus it may be inappropriate for financial services to be the subject of "reciprocal" concessions for

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(Paris: OECD, 1987). See <u>supra</u> note 101 regarding the OECD National Treatment Instrument.

[145] M. Peter McPherson, "Europe in 1992: the Outlook for Banking and Financial Services" (speech delivered to the Bankers' Association for Foreign Trade, Washingon, D.C., September 8, 1988), p. 5, and "Global Competition in Financial Services: A View From Washington" (speech delivered before the Fifth Annual San Francisco Institute of the National Center on Financial Services, University of California, Berkeley, March 2, 1989), pp. 6-9; H. Robert Heller, "Governing Banking's Future: Markets versus Regulation" (speech delivered at CATO Conference on Banking Regulation, Washington, D.C., November 2, 1988), pp. 11-12. The revised EC reciprocity proposals were released shortly before this paper went to press, and the U.S. government was still in the process of analyzing these proposals.

goods or for nonfinancial services in a global trade negotiation context. Moreover, it is conceptually and practically difficult to measure trade in financial services in a meaningful way. In part to avoid these kinds of trade-offs and measurement issues, the U.S. Treasury has always urged that trade in financial services be viewed in terms of equality of competitive opportunity in a national market for foreign and domestic financial institutions, that is, in terms of national treatment.

In discussions of reciprocity and market access, figures for relative market shares are often cited as an indicator of openness of banking markets. However, it should be emphasized that comparison of relative shares of host-country banking markets, e.g., the share of banking activity in the United States accounted for by French banks and the share of French banking activity accounted for by U.S. banks, is not a measure of "access" to the respective banking markets. Differences in observed shares of relative penetration of host-country markets depend on a variety of economic as well as regulatory factors, for example, the size of the host-country market, the extent of international banking activity conducted in the host-country market, the extent of direct investment in the host country by home-country firms, and the volume of bilateral trade. Only differences in relative market shares that could not be explained by such economic factors could be interpreted as the impact of host-country barriers to entry or restrictions on the operation of foreign banks.

Securities markets. The external dimension of the EC program for securities markets is somewhat different from that for financial services in that the securities directives explicitly provide for the possibility of mutual recognition of home-country disclosure requirements beyond the borders of the Community.[146] Under such a mutual recognition agreement, a non-EC country would be asked to recognize the disclosure requirements of the EC directive and would thus in effect be granting recognition to the rules of <u>all</u> EC countries. Since the EC policy is one of mutual rather than unilateral recognition, the EC directives provide that any such agreements with third countries would be on a reciprocal basis.

These provisions are comparable to an initiative undertaken by the U.S. Securities and Exchange Commission (SEC) to permit registration of securities based on host-country acceptance of the disclosure requirements of the home country of the issuer. This approach was first proposed in 1985[147] and has been the basis of discussions among

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[146] See <u>infra</u> Appendix C.

[147] Prior to entering into such discussions, the SEC proposed for public comments two approaches that could facilitate multinational securities offerings: (1) mutual recognition of securities prospectuses; and (2) complete harmonization, i.e., development of a common prospectus. Facilitation of Multinational Securities Offerings (SEC Release No. 33-6568, File No. 57-9-85), Request for Public Comment, 50 <u>Fed. Reg</u>. 9281 (March 7, 1985). In general, the public commments suggested that the common prospectus approach, while theoretically appealing, would not be achievable in practice and advocated use of the mutual recognition approach instead. Securities and Exchange Commission, Division of Corporation Finance, Summary of Comments on Concept Release Facilitation of Multinational Securities Offerings, January 1986. See generally Aulana L. Peters, "Overview of International Securities Regulation," <u>International Tax and Business Lawyer</u>, vol.6 (Spring 1988), pp. 229-41.

the United States, Canada, and the United Kingdom for several years.[148] Discussions with Canadian authorities are reportedly at a fairly advanced stage.

There are two stages to such discussions. The first consists of achieving a technical understanding of disclosure requirements in the issuer's home country and evaluating whether they can be recognized as providing the same degree of protection as those in the host country. The Securities and Exchange Commission purposely limited its 1985 proposal to the United Kingdom and Canada, where requirements are more similar to those in the United States than are those of other countries. Limiting the proposal to these countries could be viewed as comparable to the EC's harmonization of essential rules that is the precondition for mutual recognition.

The second stage of the discussions would become relevant if a decision were to be made that home-country disclosure standards cannot be recognized as providing the same degree of protection as those of the host country. Because sufficient regulatory harmonization would not exist, the issue would be whether to begin negotiations in an attempt to achieve some kind of agreement on minimum standards as was done within the European Community. To date, however, the U.S. Securities and Exchange Commission has not contemplated initiating such discussions.

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[148] In Canada, the provincial authorities have primary regulatory responsibility for most securities transactions. The provinces of Ontario and Quebec, where the major Canadian securities markets are located, were the primary participants in the discussions with the United States and the United Kingdom but coordinated their approach with other provinces and with the national government.

With respect to mutual funds and unit trusts, adoption of an EC directive permitting Community-wide sales under home-country control as of October 1989 has raised the question as to whether such sales could be permitted on a more global basis. Again, the basic issue is whether harmonization of minimum standards is sufficient to allow mutual recognition and home-country control. In a series of meetings beginning in December 1987, representatives of the mutual funds industry from different countries have been exploring whether sufficient harmonization exists between the European Community and third countries to permit negotiation of agreements regarding cross-border sales of mutual funds under home-country control.[149]

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[149] See Letter from David Silver, President, Investment Company Institute to David S. Ruder, Chairman, U.S. Securities and Exchange Commission, November 21, 1988.

IV. CONCLUSION

While the entire framework for the internal market, or even for the financial sector alone, may not be in place by the end of 1992, it seems probable that a critical threshold of measures will have been adopted and implemented such that, in the absence of a significant downturn in economic activity, completion of the internal market by the mid-1990s may be possible. As noted at the outset, an important development necessary to achieve this goal has already occurred: market participants are basing their plans and governments are framing their policies on the assumption that the internal market will be completed. The commitment by the more developed EC countries to use EC structural funds to assist poorer countries and regions is likely to be be an important factor in determining the willingness of the poorer countries not only to support legislation to establish the internal market in the short run but also to implement it during what might be a difficult transitional period of industrial restructuring. A further issue that has not yet been resolved is what steps might need to be taken by the Community with regard to social legislation.

The goal of free capital movements within the Community is close to realization, and, by mid-1990, eight countries will permit the unrestricted movement of capital. Integration of the EC financial sector--banking, investment services, securities markets, and insurance--is already well advanced, in part because this process is part of a larger trend toward globalization of financial services and markets and toward increased international cooperation and coordination among regulatory authorities. The financial sector may be particularly suited to the EC approach of mutual recognition and home-country control. The banking sector presents the fewest difficulties because basic harmonization with regard to consolidated supervision and capital standards has already been achieved among the major industrial countries. Investment services are more difficult because of much greater disparities in national regulatory structures and because there is no multilateral agreement on market risk equivalent to the risk-based capital accord.

Although securities markets involve complex national rules with regard to information disclosure requirements, market pressures had already led some securities regulators to explore the possibility of recognition of disclosure requirements in other countries. The insurance sector may be the most difficult of the financial sectors to integrate. Except for reinsurance, the insurance industry is much less international in character than the banking and securities industries, more barriers exist within domestic markets, and there is less consultation and cooperation internationally among regulators.

Within the European Community, mutual recognition in the financial sector is expected to lead to additional harmonization of national regulatory structures as a result of market pressures. There is always a risk that the initial harmonization of what are considered basic standards and supervisory practices will not be sufficient to prevent market pressures leading to competition in laxity among national regulatory authorities. However, it is also possible that the market would place a value on more stringent regulation and supervision. While it may be easier to make adjustments to the degree of harmonization in the financial sector, because of prudential, monetary policy, and market stability considerations the financial sector may also require a greater degree of initial harmonization than is necessary for other sectors in order to make the principle of mutual recognition acceptable.

In considering the applicability of the principle of mutual recognition beyond the Community, it is important to keep in mind that within the Community mutual recognition involves political compromises to achieve a common goal and that the principle of mutual recognition has been accepted and implemented within an established supranational legislative and judicial structure. Even within this framework, there are many unresolved issues with regard to the extent to which national sovereignty is transferred to the Community, particularly with reference to the powers of the Commission and to concerns about the democratic foundations of Community institutions.

Both the approach of mutual recognition used within the Community and the reciprocity approach apparently being adopted for third countries are relevant to the question of the interaction and appropriate relationship of different national regulatory structures in response to the internationalization of financial activity. The 1985 White Paper did not address the external dimension of the program to complete the internal market, and the approach to treatment of third-country institutions has been developed in the context of individual directives. Although, as of this writing, the EC Commission has recently revised its reciprocity proposal for banking services, some ambiguities still remain. In terms of entry, it appears that reciprocity will, at a minimum, mean reciprocal national treatment; the criteria may also include the concept of effective market access, which involves both national treatment and the liberalization of host-country financial structure. In terms of negotiating goals, the EC proposal appears to include not only the concept of effective market access but also the concept of better than national treatment, which could be viewed as the equivalent of an attempt to apply the principle of mutual recognition without harmonization of basic standards.

If mutual recognition were to be used on a more global basis to achieve financial integration, agreements among nations on basic rules and on goals for regulatory convergence would be necessary. At present, the approach of mutual recognition is being explored as a basis for financial integration outside the Community only with regard to disclosure requirements for securities and only among countries in which it is hoped that existing rules will be found to be sufficiently similar so that negotiated harmonization will not be necessary. Moreover, any agreements in this area, in contrast to banking and investment services, would involve primarily issues of investor protection rather than prudential concerns. In the banking, investment services, and insurance sectors, national treatment, as embodied in the OECD Codes of Liberalisation and the National Treatment Instrument, is in general the currently accepted approach. Whether national treatment or effective market access might become the accepted approach if any agreement is reached on trade in financial services in connection with the current Uruguay Round of GATT negotiations remains to be seen.

Financial services, because of the inherent public policy interests, remain different from other types of services. For that reason, it is often argued that trade in financial services should be addressed separately from trade in other services and goods. For example, the international coordination and harmonization of rules that has been achieved to date in the banking sector has been accomplished in a relatively informal way: the Basle risk-based capital framework is an accord among the banking authorities of the major industrial countries rather than a formal international agreement or treaty. It was negotiated under the auspices of the BIS Committee on Banking Regulations and Supervisory Practices, which was established in the mid-1970s as a mechanism for regular consultation among the banking authorities of the major industrial countries. Moreover, questions relating to implementation of the capital guidelines or adaptation of guidelines to changes in market practices will be dealt with as part of the continuing work of the BIS Committee.

As in the banking sector, international regulatory issues involving securities firms or markets are dealt with by contacts among the regulatory authorities. However, there is no equivalent of the BIS Committee for the securities sector. Mechanisms for multilateral cooperation and harmonization of rules in the securities area are in the process of development, a process that is being facilitated by technical committees set up under the auspices of the International Organization of

Securities Commissions. To date, however, the primary discussions and "understandings" reached among securities regulators continue to be on a bilateral basis. Because the insurance industry has not undergone the same degree of globalization as the banking and securities sectors, at present there is no formal multilateral group of insurance regulators. The Organisation for Economic Co-operation and Development remains the primary forum for multilateral discussions of barriers to trade in insurance services.

In the worst case, the EC proposals for reciprocity in the financial sector could impede both the internationalization of financial services and markets and the movement toward increased regulatory cooperation and convergence. For example, if some non-EC financial firms were to be placed at a competitive disadvantage in EC markets, pressures could be created for retaliatory measures in the firms' home countries. Within the Community, it is possible that the program for completion of the internal market could be associated with increased political pressures for a more protectionist trade policy. Reciprocity provisions and other barriers to international trade in goods or services could be established and strictly interpreted as a political response to what is likely to be a difficult period of industrial restructuring during which efficient producers of goods or services increase their market share and inefficient producers (if not subsidized by their governments) are forced out. In addition, any significant downturn in economic activity within the Community could create additional pressures for restrictive external policies.

However, the internal market program is more likely to have beneficial effects externally as well as internally. In the financial sector, completion of the internal market program will create a coordinated regulatory framework for financial services and markets and thereby remove existing barriers to Community-wide competition, including those resulting from non-discriminatory differences in national rules. In addition to deregulation mandated by EC directives, actual or potential competition could be expected to create pressure for liberalization of rules in domestic markets that are currently highly regulated and restricted. With regard to the external dimension, it could be hoped that, rather than the EC reciprocity proposals leading to the creation of new barriers, the liberalizing measures being taken within the Community will serve as a catalyst for further international progress with regard to trade in financial services. As already noted, the internationalization of financial services and markets has both facilitated and created a need for increased regulatory and supervisory cooperation and coordination. The internal and external dimensions of the EC internal market program could be a significant contribution to this process.

APPENDIX A: BANKING

The EC's Second Banking Directive, which was proposed by the Commission in early 1988 and is expected to be acted upon by the Council during 1989, is viewed as the centerpiece of EC banking legislation because it is a comprehensive proposal that would govern the geographic expansion and powers of banks within the Community. Under the proposed directive, a credit institution would be able to provide services throughout the Community--either through branches or across borders--under home-country control. As a result, a bank could branch Community-wide without the necessity of obtaining an authorization from the host country for each branch. The directive also introduces a list of "universal" banking powers for EC banks, which includes all forms of securities activities, but not insurance activities. If a bank's home country permits a bank to engage in a listed activity, the bank may conduct that activity anywhere in the Community regardless of host-country law.

Establishment and Acquisition of Subsidiaries. With the exception of a requirement for prior consultation,[150] the establishment of subsidiaries in other member states is not specifically addressed by the Second Banking Directive. Such subsidiaries would continue to be subject to host-country control, that is, they would be chartered by the host country and subject to its laws and regulations, including those

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[150] Proposed Second Banking Directive, art. 6.

relating to permissible activities.[151] The "right of establishment" set forth in the Treaty of Rome theoretically precludes a member state from blocking acquisitions of its firms by residents of other EC countries on the grounds of foreign ownership.[152] Under a merger regulation proposed by the Commission in 1988, mergers and acquisitions "having a Community dimension" would be subject to review by the EC Commission on the basis of competitive effects.[153] The Commission would in effect replace national antitrust authorities in both approving and disapproving such mergers and acquisitions.[154] EC rules regarding one method of effecting an acquisition, namely, takeover bids, are set forth in a directive

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151 The parent bank would, however, be supervised on a consolidated basis as provided by a 1983 EC directive. Council Directive of 13 June 1983 on the supervision of credit institutions on a consolidated basis (83/350/EEC) [hereinafter Consolidated Supervision Directive], 26 O.J. Eur. Comm. (No. L 193) 18 (1983).

152 Treaty of Rome, arts. 52-56.

153 Commission of the European Communities, "Amended proposal for a Council Regulation (EEC) on the control of concentrations between undertakings" [hereinafter Proposed Merger Regulation], COM(88) 734 final (rev.) (December 19, 1988). The proposal defines a concentration as having a "Community dimension" if the aggregate worldwide turnover of all the undertakings concerned is more than ECU 1 billion (approximately $1.1 billion) and the aggregate Community-wide turnover of each of at least two of the undertakings concerned is more than ECU 100 million (about $110 million); an exception is made if each of the undertakings involved has more than three-quarters of its aggregate Community-wide turnover within the same member state. Id., art. 1.

See supra note 21 regarding the distinction between a regulation and a directive. The Commission based the proposed regulation on an article of the Treaty of Rome that requires the Council to adopt the measure by a unanimous vote. See Proposed Merger Regulation, preamble, p. 3, and Treaty of Rome, art. 235.

154 Id., preamble, para. 27; art. 8.

adopted by the Council in December 1988.[155]

In theory if, for example, a German bank met the EC and U.K. standards (which could be stricter) for authorization of a credit institution and if the acquisition were permissible under EC competition policy, the German bank should be able to acquire a British clearing bank. However, in practice the United Kingdom might try to limit the extent of such acquisitions.[156] The preamble to the proposed merger regulation appears to allow for the possibility of national restrictions on grounds other than competition but the scope of the exception is not clear.[157] Resort to the European Court of Justice might be required in order to determine under what circumstances, if any, a member state could restrict banks from other EC countries from acquiring domestic banks.

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155 Commission of the European Communities, "Proposal for a Thirteenth Council Directive on Company Law concerning takeover and other general bids" [hereinafter Proposed Takeover Directive], COM(88) 823 (December 22, 1988).

156 The Governor of the Bank of England has stated his belief that "it is of the highest importance that there should be a strong and continuing British presence in the banking system of the United Kingdom. It runs counter to commonsense to argue that the openness of the London market must be carried to the point where control of the core of our financial system--the payments mechanism, the supply of credit--may pass into the hands of institutions whose business aims and national interest lie elsewhere." Robin Leigh-Pemberton, "Ownership and control of UK banks," Bank of England Quarterly Bulletin, vol. 27 (November 1987), p. 526.

157 The preamble states that the Commission's authority would not prevent the member states from "taking appropriate measures...to protect legitimate interests other than those pursued by this Regulation, provided that such interests are sufficiently defined and protected by domestic law and that such measures are compatible with other provisions of Community law." Proposed Merger Regulation, preamble, para. 28.

Harmonization of essential laws and regulations. Some of the harmonization deemed necessary for mutual recognition and home-country control to be acceptable in the area of banking has already been accomplished. The First Banking Directive, adopted in 1977, provided for authorization and supervision by the home country and cooperation among supervisory authorities.[158] A 1983 directive provided for the supervision of credit institutions on a consolidated basis,[159] and a 1986 directive provided for common accounting rules for the consolidated accounts of EC financial institutions.[160] The Commission proposes to implement the Second Banking Directive simultaneously (no later than January 1, 1993) with measures to harmonize bank capital standards based on the framework developed by the Basle Committee on Banking Regulations and Supervisory Practices.[161] These measures comprise the "own funds" directive, which defines capital and was approved by the Council in

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[158] See supra note 136.

[159] See supra note 151.

[160] Council Directive of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions (86/635/EEC), 29 O.J. Eur. Comm. (No. L 372) 1 (1986). This directive is part of the EC company law program in that it contains exceptions to accounting rules set forth in the company law directives.

Under a 1989 directive, host states may not require branches of banks from other member states to publish individual branch accounts. Branches of non-EC banks are exempt from publishing such accounts only if the home-country documents are considered equivalent to those required by the European Community and the home country provides reciprocal treatment for EC banks. Council Directive of 13 February 1989 on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents (89/117/EEC), 32 O.J. Eur. Comm. (No. L 44) 40 (1989).

[161] See supra note 75.

December 1988,[162] and the solvency ratio directive, which specifies risk-adjusted capital ratios and has not yet been acted upon by the Council.[163]

Other measures that will be part of the harmonization of essential rules include reporting of large exposures, development of deposit insurance programs, and a European code of conduct for electronic payment. In these areas, the Commission has made recommendations, which do not have the force of law, and plans to propose directives in the future.[164] In addition, the Commission has also proposed a directive dealing with liquidation of failing institutions; this directive also addresses the issue of deposit insurance programs.[165] In general, under the Commission's recommendation for development of deposit insurance programs, deposit insurance for branches of banks from another member

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162 See supra note 76.

163 See supra note 77.

164 Commission Recommendation of 22 December 1986 concerning the introduction of deposit-guarantee schemes in the Community (87/63/EEC), 30 O.J. Eur. Comm. (No. L 33) 16 (1987); Commission Recommendation of 22 December 1986 on monitoring and controlling large exposures of credit institutions (87/62/EEC), 30 O.J. Eur. Comm. (No. L 33) 10 (1987); Commission Recommendation of 8 December 1987 on a European Code of Conduct relating to electronic payment (87/598/EEC), 30 O.J. Eur. Comm. (No. L 365) 72 (1987).

165 Commission of the European Communities, "Amended Proposal for a Council Directive concerning the reorganization and the winding-up of credit institutions and deposit-guarantee schemes" [hereinafter Proposed Liquidation Directive], COM(88) 4 final (January 4, 1988).

state would be the responsibility of the host country.[166] However, as a transitional measure, pending adoption of such programs by all of the member states, the proposed liquidation directive provides that if a deposit-insurance program does not exist in the host country, the home country must cover such branches under its own program.[167]

In addition to the harmonization measures covered in other directives, the proposed Second Banking Directive itself specifies certain conditions that a bank must fulfill in order to establish branches without host-country licensing. Specifically, the directive contains a minimum initial capital requirement of ECU 5 million (about $5.5 million)[168] and provisions relating to the identity, extent of holdings, and suitability of major shareholders.[169] The directive also contains a provision limiting a bank's ownership of stock in an individual non-financial enterprise to 10 percent of the bank's capital; the aggregate amount of such holdings is limited to 50 percent of

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166 At present, some member states are still in the process of developing or introducing deposit insurance programs. The types of programs that do exist vary considerably, ranging from formal statutory schemes to programs set up on a voluntary basis by banking associations.

167 Proposed Liquidation Directive, art. 16.

168 Proposed Second Banking Directive, art. 3.

169 _Id_., art. 4. With regard to qualifications, the directive provides only that "the competent authorities shall appraise the suitability of the ...shareholders or members." _Id_.

capital.[170] Alternatively, a bank may have an ownership interest in excess of these limits provided that the amount of the investment is deducted from the bank's capital for purposes of prudential requirements.[171] The restrictions do not apply to investments held through a holding company structure.

Definition of a credit institution. The proposed Second Banking Directive would retain the present EC definition of a "credit institution" that was set forth in the First Banking Directive, specifically, "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account." This narrow or traditional definition of a bank is usually justified on the grounds that the primary objective of prudential supervision is the protection of depositors and of the payment system. However, the definition covers only deposit-taking institutions that also grant loans.

In formulating the Second Banking Directive, the Commission had originally suggested broadening the definition of a credit institution to

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170 *Id.*, art. 10. Because insurance companies do not fall within the EC definition of a financial institution, investments in insurance companies would be subject to these limitations. A financial institution is defined by reference to the 1983 directive on consolidated supervision as an undertaking other than a credit institution "whose principal activity is to grant credit facilities (including guarantees), to acquire participations, or to make investments." Consolidated Supervision Directive, art. 1.

171 Proposed Second Banking Directive, art. 10.

include undertakings that either receive deposits or grant credits.[172] The rationale for a broader definition was that competitive equality in regulation of competing financial institutions would be enhanced and that the purpose of prudential supervision should be more broadly construed to include ensuring the overall stability of financial markets. Covering only deposit-taking institutions was considered insufficient on the grounds that financial market stability could be endangered by failure of an institution that engages only in lending activities but finances such activities from the interbank market.[173] However, the proposed coverage of such lending institutions would have widened the scope of the directive considerably and was strongly opposed by some member states.[174]

Single license and home-country control. Branches of EC banks established throughout the Community under the proposed Second Banking Directive would be authorized and supervised by the home country.[175] Unlike the present situation in some host countries, there would be no

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172 See George S. Zavvos, "Towards a European Banking Act," Common Market Law Review, vol. 25 (1988), p. 273; British Bankers' Association, supra note 122, pp. 21-22; Paul Tillett, "1992 and All That," Banking World, vol. 6 (June 1988), p. 27.

173 Zavvos, supra note 172, p. 273. See Tommaso Padoa-Schioppa, supra note 79, pp. 24-26. See also Bank for International Settlements, Recent Innovations in International Banking (Basle: BIS, 1986), pp. 239-41.

174 See Zavvos, supra note 172, p. 273, and British Bankers' Association, supra note 122, pp. 21-22.

175 The proposed Second Banking Directive would amend the First Banking Directive, which provided for host-country as opposed to home-country control of branch operations. Existing branches would automatically be deemed to have satisfied the procedures set forth in the Second Banking Directive and thus be able to benefit from its provisions. Proposed Second Banking Directive, art. 21.

limitation on the number of branches that could be established in any one country. In general, branches established under the proposed Second Banking Directive would be free from host-country regulatory and supervisory requirements. For example, they would no longer be subject to the "dotation" or endowment capital requirements currently imposed by all Community countries except the United Kingdom. Also, present host-country solvency ratios and restrictions on large exposures based on branch capital would no longer be applicable.

Explicit exceptions to home-country control. Host countries would, however, be permitted to apply rules relating to the conduct of monetary policy and branch liquidity and other rules that could be justified on the basis of the public interest such as consumer protection laws.[176] In addition to acknowledging the public interest exception to the principle of home-country control, the proposed Second Banking Directive provides for three specific exceptions.

First, the the host-country would retain exclusive responsibility for measures resulting from the implementation of monetary policy.[177] Such measures would include, for example, setting of reserve requirements and interest rate ceilings.[178]

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176 See supra Section III.A.

177 Proposed Second Banking Directive, art. 12.

178 In this regard, the directive specifies that branches should provide the host country authorities, if so required, the same amount of information as is required for domestic credit institutions for the purpose of monitoring liquidity and of monetary control. Proposed Second Banking Directive, art. 19.

Second, "until further coordination," the host country would retain primary responsibility for the supervision of liquidity, that is, for ensuring that banks operate in such a way as to meet their obligations as they fall due.[179] This assignment of responsibility is consistent with general international practice under the Revised Basle Concordat, which provides that the host authority has primary responsibility for monitoring the liquidity of branches of foreign banks established in its country, while the country of the parent bank has responsibility for monitoring the liquidity of the banking organization as a whole.[180]

Third, at the insistence of the United Kingdom, "until further coordination," the host country would be permitted to require credit institutions authorized in another member state "to make sufficient provision against market risk" with respect to operations in host-country securities markets.[181] This provision for host-country control with regard to capital requirements for securities activities appears to have been preempted by a provision for <u>home</u>-country control in the proposed Investment Services Directive.[182] However, the provision in the proposed Investment Services directive refers to the requirements of a companion market risk directive now being developed by the Commission; such a

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179 <u>Id</u>.

180 See Revised Basle Concordat, 22 I.L.M. at 907 (1983).

181 Proposed Second Banking Directive, art. 19.

182 See <u>infra</u> Appendix B.

directive would in any event provide the further coordination required by the proposed Second Banking Directive.[183]

List of activities. The proposed Second Banking Directive sets forth a list of activities that are considered integral to banking by the European Community.[184] The list of activities is very broad in that it includes all types of securities activities, but it does not include insurance activities. Under the terms of the directive, branches of banks chartered by individual EC member states would be permitted to engage in any of the listed activities provided that the EC home country permits such activities; cross-border provision of services by home-country banks could be offered on a similar basis. The directive does not address the question of cross-border provision of services by branches, that is, whether a French branch of a U.K. bank could offer cross-border services to customers in Belgium involving any listed activity that is permissible in the United Kingdom.

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[183] Proposed Investment Services Directive, art. 8. See also id., explanatory memorandum, p. 2.

[184] The listed activities are as follows: (1) deposit-taking and other forms of borrowing; (2) lending, including consumer credit, mortgage lending, factoring and invoice discounting, and trade finance (including forfaiting); (3) financial leasing; (4) money transmission services; (5) issuing and administering means of payment (credit cards, travellers checks and bankers drafts); (6) guarantees and commitments; (7) trading for own account or for account of customers in (a) money market instruments (checks, bills, CDs, etc.), (b) foreign exchange, (c) financial futures and options, (d) exchange and interest rate instruments, and (e) securities; (8) participation in share issues and the provision of services related to such issues; (9) money brokering; (10) portfolio management and advice; (11) safekeeping of securities; (12) credit reference services; and (13) safe custody services. Proposed Second Banking Directive, annex.

Under the Second Banking Directive, if the EC home country permits a bank to engage in a listed activity, the bank may engage in that activity through a branch or through cross-border provision of services anywhere in the Community regardless of whether that activity is permitted to banks in the EC host country. This contrasts with the present situation which is basically one of national treatment, that is, the activities of foreign banks in the host country are limited to those permitted to host-country banks.[185]

In some EC countries, banking institutions may not engage directly in certain of the activities listed in the proposed Second Banking Directive (e.g., leasing, factoring, dealing in securities, mortgage credit), although they are permitted to do so through subsidiaries. Such subsidiaries do not, however, fall within the EC definition of a credit institution. The directive addresses this issue by permitting such subsidiaries to benefit from its provisions with respect to cross-border services and Community-wide branching provided that the subsidiaries meet certain ownership and control conditions designed to ensure that they are integral parts of the parent credit

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185 At present, however, some existing branches, for example, a London branch of a bank from another member state, may be permitted to engage in certain activities or offer certain instruments in the host country (the United Kingdom) that are not permissible in the bank's home country. The question of whether such host-country powers of existing branches would be grandfathered is not addressed in the directive.

institution.[186]

Questions have been raised as to how the list of activities set forth in the Second Banking Directive will work in practice. One issue is whether difficulties will arise in distinguishing between the service itself, which is subject to home-country control, and the manner in which it is offered, which is subject to host-country control.[187] For example, banks are permitted to offer variable rate mortgages in some member states but not in others. Presumably the variable rate is an integral part of the mortgage service being offered under home-country control; however, it could be argued that the mortgage is the listed service and the variable rate is the way in which the service is provided and thereby under the jurisdiction of the host state on the basis of consumer protection concerns (or perhaps on the basis of monetary policy concerns). If the directive is ambiguous and host-countries apply their national rules, it seems likely that such issues will be decided by the European Court of Justice.

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[186] The conditions are as follows: (1) the subsidiaries must be fully consolidated with those of the parent; (2) the parent must hold at least 90 percent of the shares of the subsidiary; (3) the parent must accept full responsibility for the subsidiary. Proposed Second Banking Directive, art 16. Securities subsidiaries would be covered by the proposed Investment Services Directive. See <u>infra</u> Appendix B. A separate directive for mortgage institutions was proposed by the Commission prior to the development of the proposed Second Banking Directive; it is not clear what provisions of the mortgage directive are still necessary. Commission of the European Communities, "Amended Proposal for a Council Directive on the freedom of establishment and the free supply of services in the field of mortgage credit," COM(87) 255 final (May 22, 1987).

[187] British Bankers' Association, <u>supra</u> note 122, p. 54.

A further question arises with regard to services that are not listed in the Second Banking Directive. If the unlisted services are permitted in the home country, the judgments of the European Court of Justice in the insurance cases suggest that a host country could not restrict such services provided across borders unless the restriction could be justified on the grounds of the public interest. The issue of services provided by branches has not been addressed by the Court but, as discussed above, the Commission appears to assume that the same public interest criterion would apply.[188] It seems likely that host-country restrictions on non-listed services--including the situation in which a branch of a bank from another member state wishes to provide an unlisted service permitted by the home country but prohibited or restricted by the host country--will be the subject of future litigation.

Powers of the Commission. Under the proposed directive, the Commission is given discretionary power, subject to the approval of a committee of representatives from the member states, to expand the list of activities integral to banking, to change the initial capital requirements set forth in the directive, to change the limits on investments in nonfinancial enterprises, and to modify the areas in which the supervisory authorities are required to exchange information.[189] A similar procedure would apply to the exercise of the Commission's power to take steps to limit or bar entry of non-EC banks under the reciprocity

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[188] See supra Section III.A.

[189] Proposed Second Banking Directive, art. 20.

clause. Reportedly, some member states believe that the proposals could result in too much power being delegated to the Commission.

Reciprocity Proposals. A summary of the EC reciprocity proposals is given in Section II.B above and the general principles with regard to treatment of non-EC banking organizations are discussed in Section III.B above. This appendix presents a more detailed explanation of the reciprocity provision in the proposed Second Banking Directive, including the revisions recently announced by the Commission.

With regard to EC subsidiaries of non-EC banks, the Commission's explanatory memorandum accompanying the proposed Second Banking Directive notes that under the Treaty of Rome, any companies incorporated in a member state are considered to be EC companies regardless of their ownership.[190] On the basis of this provision of the Treaty, it appears that existing banking subsidiaries of non-EC banks would be accorded national treatment, that is, they would be treated like any other bank in the member state in which they were chartered and could therefore branch freely throughout the Community without having to obtain a license from

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190 Proposed Second Banking Directive, explanatory memorandum, pp. 7-8. The Treaty of Rome provides that "[c]ompanies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall...be treated in the same way as natural persons who are nationals of Member States." Treaty of Rome, art. 58.

each host country.[191] Although some early statements by EC officials had raised questions as to whether a reciprocity requirement might be applied to existing institutions, the Commission has now made it clear that reciprocity would not be applied retroactively.[192]

For future entry by non-EC banks through the subsidiary form of organization (but not through branches), the proposal would establish a Community-wide principle of reciprocity. Under this principle a non-EC bank would not be permitted to establish a subsidiary in any member state unless its home country granted reciprocal treatment to banks from all member states. In the revised reciprocity proposal released on April 13, 1989, the Commission appears to distinguish between the criteria that

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[191] If the EC subsidiary of a non-EC banking organization does not meet the definition of a credit institution (such as, for example, a finance or leasing subsidiary), the subsidiary would not be eligible for the branching benefits under the Second Banking Directive. In order to be able to take advantage of these benefits, the credit institution owning the subsidiary would have to be incorporated within the Community and subject to EC regulations. (In addition, the subsidiary would have to meet certain tests. See supra note 186.) A finance or leasing subsidiary of a non-EC credit institution could, however, to the extent permitted by national legislation, establish branches individually licensed by the host country.

[192] The explanatory memorandum accompanying the proposed Investment Services Directive states that "[a]s in the case of the banking Directive, the reciprocity regime does not apply to existing investment businesses already established in the Community." Proposed Investment Services Directive, explanatory memorandum, p. 5.

A question that has not yet been addressed is whether the grandfathered status of existing subsidiaries would be affected by certain changes in ownership of an EC subsidiary (e.g., as part of a bank holding company merger or acquisition within the United States), by corporate reorganizations involving EC subsidiaries (e.g., transferring the ownership of the subsidiary from a bank to a bank holding company), or by an attempt by an EC subsidiary to merge with or to acquire another EC institution.

could be used to limit or to bar entry to the EC market and the criteria that could be used as a goal in entering into negotiations with third countries.[193] The new proposal also provides for a much less cumbersome review procedure than the procedure that had been originally proposed.

Under the revised proposal, prior to the effective date of the directive and periodically thereafter, the Commission would make a determination regarding the treatment of EC banks by third countries.[194] Each member state would be required to inform the Commission of any request by a third-country institution to establish or acquire a subsidiary. The Commission could require the host member state to "limit or suspend" its decision regarding the application only if the treatment accorded to EC banks by the home country had been determined to be unsatisfactory.[195] In contrast to the earlier proposal, there would be no automatic "suspension of the decision" while the Commission reviewed the treatment of EC banks in the home country.[196]

The Commission could take action to limit or block an application by a bank from a third country if it had determined on the

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[193] See supra note 94.

[194] Revised Reciprocity Proposal, para. 3.

[195] Id., paras. 1,5. For purposes of the reciprocity test, the parent organization is considered to be the ultimate foreign owner, not, for example, an intermediate company established within the Community or in a country such as Switzerland. The European Parliament had suggested this clarification to the original proposal. European Parliament, Minutes, supra note 135, p. 32. See also Hal S. Scott, "La Notion de Réciprocité dans la Proposition de Deuxième Directive de Coordination Bancaire," Revue du Marché Commun, no. 323 (January 1989), p. 48.

[196] Proposed Second Banking Directive, art. 7.

basis of its periodic studies "or at any other time" that the third country did not provide EC credit institutions with "national treatment and the same competitive opportunities as domestic credit institutions... and that the condition of effective market access has not been secured."[197] While the first part of the condition is quite clear (i.e, national treatment and equality of competitive opportunity in domestic markets), as of this writing, the implications of the inclusion of the condition of effective market access remain unclear. An EC press release states that entry for banks from "any country providing genuine national treatment to Community banks" would not be restricted.[198] In this context, it appears that "genuine national treatment" may simply refer to de facto in addition to de jure national treatment.

In a separate clause, the Commission's revised reciprocity proposal provides that if a third country does not grant EC banking institutions "effective market access and competitive opportunities comparable to those accorded by the Community," the Commission may submit proposals to the Council to enter into negotiations with third countries to try to achieve such access and opportunities.[199] This clause appears to set forth as goals for negotiation both the concept of effective

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[197] Revised Reciprocity Proposal, para. 5.

[198] April 13 Press Release, p.2.

[199] Revised Reciprocity Proposal, para. 4.

market access and the concept of better than national treatment.[200] The fact that effective market access in included both as a possible condition of entry and as a negotiating goal may represent a political compromise within the Community. However, in view of the Commission's stated purpose of using a reciprocity provision to strengthen its bargaining position in bilateral or multilateral negotiations,[201] it might have been considered necessary to provide that effective market access could be not only a negotiating goal but also a possible basis for taking action to limit or to bar entry.

In addition to the EC reciprocity provision, future entry of non-EC banking organizations would continue to be subject to host-country licensing and authorization standards. If such entry were in the form of an acquisition of or merger with an EC bank, it could also be subject to review by the Commission under EC competition rules, which are in the process of development.[202] In the case of a merger or acquisition involving a company from outside the Community, it appears that member states would not be required to remove any barriers to non-EC direct

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[200] See supra Section III.B. Because "opportunities comparable to those afforded by the Community" is being used as a goal rather than as a condition of entry, the relevant concept is better than national treatment as opposed to mirror-image reciprocity.

[201] See supra note 143.

[202] See supra pp. 83-85.

investment that are now in effect.[203]

Direct branches of non-EC banks would not benefit from the provisions for Community-wide expansion in the proposed Second Banking Directive and would not be subject to its reciprocity provision.[204] Such branches would continue to be licensed by individual member states and would be subject to host-country regulatory and supervisory requirements under the terms of the EC's First Banking Directive. As a result, unlike branches of EC banks, direct branches of non-EC banks would be continue to be subject to endowment capital requirements in all member states except the United Kingdom and also to any branch solvency ratio requirements that may be imposed by the host country. The European Parliament has proposed EC initial capital and solvency ratio requirements for direct branches of non-EC banks, but the Commission has indicated its disagreement with these proposals.[205]

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[203] The preamble to the proposed merger regulation addresses the question of national rules for purposes other than competition. (See supra note 157.) Rules applicable to non-EC firms--in contrast to rules applicable to firms from other member states--would appear to be difficult to challenge as incompatible with other provisions of Community law.

With regard to takeovers, the directive proposed by the Commission in December 1988 does not contain a reciprocity clause but the Commission's explanatory memorandum makes it clear that individual member states may block bids from a non-EC firm if EC companies are effectively barred from takeovers in the firm's home country. Proposed Takeover Directive, explanatory memorandum, pp. 5-6.

[204] See supra Section III.B.

[205] See supra note 135.

U.S. banks have a substantial presence in EC countries and EC banks in turn have a substantial presence in the United States.[206] As of December 1987, branches and subsidiaries of U.S. banking organizations located in the European Community had total assets of about $215 billion. In general, EC branches of U.S. banks are located in major financial centers and are engaged primarily in wholesale banking activities. Branches located in London accounted for more than three-quarters of the $140 billion in total assets at EC branches of U.S. banks as of December 1987. The EC subsidiaries of U.S. banking organizations include banks (some of which engage in securities activities), investment firms, and finance and leasing companies.[207] Total assets of these institutions amounted to nearly $75 billion as of December 1987; more than half of this amount was accounted for by subsidiaries located in the United Kingdom.

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[206] Within the United States, banks from EC countries account for about one-quarter of total assets at U.S. offices of foreign banks. As of December 1987, the U.S. banking offices of EC banks--including agencies, branches, commercial bank subsidiaries, New York state investment companies, and Edge corporations--had total assets of nearly $150 billion, with U.K., Italian, French, and German banks having the largest U.S. presence.

[207] At present, some of these subsidiaries have branches in other countries within the Community for which they obtained separate licenses from the individual host countries.

APPENDIX B: INVESTMENT SERVICES

The securities directive that is the counterpart of the Second Banking Directive was proposed by the Commission in December 1988.[208] Like the Second Banking Directive, the proposed Investment Services Directive provides for removal of barriers to both the provision of cross-border services and the establishment of branches throughout the Community based on the principles of harmonization of essential standards, mutual recognition, and home-country control. Investment firms, like credit institutions, would be able to establish branches throughout the Community without obtaining a license from the host country for each branch. In order to ensure that such branches are able to compete effectively in the host country, the directive also provides for liberalization of rules governing access to stock exchanges and to financial futures and options exchanges.

Definition of an investment firm. In contrast to the proposed Second Banking Directive, the proposed Investment Services Directive adopts a functional rather than an institutional approach to the definition of an investment firm.[209] As discussed above, the Second Banking Directive defines a credit institution separately from the activities in which such an institution would be allowed to engage. By contrast, the Investment Services Directive defines an investment firm as

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[208] See *supra* note 80.

[209] Proposed Investment Services Directive, art. 1. See also Tommaso Padoa-Schioppa, *supra* note 79, pp. 19-20.

a firm that engages in any of the activities listed in the directive. These services include brokerage, dealing as principal, market making, portfolio management, underwriting, investment advice, and safekeeping services (other than in conjunction with management of a clearing system) that involve any of the instruments specified by the directive.[210]

Investment firms that engage in these activities include firms that are also credit institutions that would be governed by the Second Banking Directive. The Investment Services Directive takes account of this overlap by specifying that only certain articles of the directive will be applicable to investment firms that are also credit institutions.[211] (A subsidiary of credit institution that is an investment firm but is not itself a credit institution would be governed by the provisions of the Investment Services Directive, not by the provisions of the Second Banking Directive.) With regard to the question of home- or host-country control of capital requirements for securities activities of credit institutions, the provisions of the Investment Services Directive, in conjunction with the market risk directive now being developed by the Commission, appear to preempt the provisions of the Second Banking Directive.[212] The Commission intends

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210 The instruments listed are as follows: (1) transferable securities (including UCITS); (2) money-market instruments (including certificates of deposit and Eurocommercial paper); (3) financial futures and options; and (4) exchange rate and interest rate instruments. Proposed Investment Services Directive, annex.

211 Id., art. 2.

212 See infra pp. 107-09.

that the proposed Investment Services Directive and the proposed Second Banking Directive would enter into force simultaneously in order to achieve a level playing field between securities firms (including securities subsidiaries of banks) and banks conducting securities activities.

Harmonization of essential laws and regulations and home-country control. The proposed Investment Services Directive provides for harmonization of essential laws and regulations in terms of goals rather than in terms of specific requirements. The proposed directive requires home-country authorization for an investment firm (other than a credit institution[213]) subject to three rather general conditions:[214] first, that the firm has "sufficient initial financial resources" for the activities it intends to undertake; second, that the managers of the firm are of "sufficiently good repute and experience;" and third, that the firm's shareholders are "suitable persons."[215]

The proposed directive also requires each country to formulate prudential rules that must be met on an ongoing basis by investment firms

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213 An investment firm that is also a credit institution would not need to be authorized under the proposed Investment Services Directive provided that the institution is authorized by its home-country regulatory authorities to engage in specified investment activities. Proposed Investment Services Directive, art. 4.

214 The proposed Investment Services Directive defines the authorities responsible for authorization and supervision to include both public authorities and duly authorized professional associations. In the event that there are several competent authorities, the directive requires their close collaboration. Id., arts. 14, 15.

215 Id., art. 4.

authorized in that country. These rules must ensure that the firm has sound internal control mechanisms, that assets of investors and of the firm are not commingled, that the firm participate in a general compensation scheme to protect investors in the event of bankruptcy or default, that adequate records be kept and be provided to the authorities, and that conflicts of interest be reduced to a minimum.[216]

The directive also provides that the home state authorities must require investment firms to make sufficient provision against market risk according to rules to be set forth in a companion directive.[217] Although the Commission is still in the process of developing a market risk directive (which would be the equivalent of the own funds and solvency ratio directives applicable to credit institutions), the Commission hopes that such a directive could come into force simultaneously with the Investment Services Directive. On this basis, the proposed Investment Services Directive provides that the home country will be responsible for supervising the capital adequacy and financial soundness of an investment firm and its branches throughout the Community.

This provision applies to investment firms that are also credit institutions and thus appears to preempt the provision in the Second Banking Directive that retains host-country control for capital requirements for the securities activities of credit institutions "until

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[216] Id., art. 9.

[217] Id., art. 8.

further coordination."[218] However, the market risk directive is in any event expected to provide the further coordination considered necessary for home-country control under the Second Banking Directive. Thus, if the three directives are implemented simultaneously, the provisions of the banking and investment services directives with regard to the securities activities of credit institutions would be consistent.[219] The Investment Services Directive also specifically prohibits the host country from applying an endowment capital requirement or any measure having an equivalent effect.[220] This provision would also appear to preempt the exception made in the Second Banking Directive for securities activities of credit institutions.

It is expected that the market risk directive will set forth the method by which its capital adequacy provision would be applied to the securities activities of banks. One possibility is that credit institutions would be required to segregate their activities in order to permit their banking activities to be subject to the capital requirements based on the Basle framework, while their securities activities (which would presumably be measured by an indicator of volume of activity rather than assets in order to reflect exposure), would be subject to the requirements of the market risk directive. It is not clear whether the

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[218] See <u>supra</u> Appendix A.

[219] If adoption of the market risk directive were to be delayed, it is not clear whether the provision for home-country control in the Investment Services Directive could be fully implemented. See Proposed Investment Services Directive, preamble, p. 2.

[220] <u>Id</u>., art. 10.

capital requirements would be additive or whether capital could serve both purposes.

Exceptions to home-country control. The public interest remains the general exception to home-country control. However, two areas in which further harmonization is required are mentioned specifically. The first relates to conduct of business rules that regulate the relationship between the investment firm and its customers. Pending development and enactment of a directive that would harmonize such rules, host-country control is retained in this area.[221] The preamble to the proposed Investment Services Directive notes, however, that in accordance with the judgments of the European Court of Justice, any conduct of business rules imposed by the host country would have to be justified on the grounds of the public interest.

The directive also provides that pending further harmonization of compensation schemes designed to protect investors against default or bankruptcy of an investment firm, branches of investment firms will be subject to the compensation system in force in the host member state.[222] However, the firm's contribution to the host-country fund would be assessed on the basis of the income of the branch alone. (Services provided across borders would be subject to the firm's home-country compensation system.)

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[221] Id., art. 13, explanatory memorandum, p. 3.

[222] Id., art. 9, explanatory memorandum, p. 2.

Access to markets and exchanges. The proposed Investment Services Directive provides for liberalization of access to stock exchange membership in countries throughout the Community for investment firms authorized in their home member state. A host state is required to ensure that an investment firm that is authorized to provide brokerage, dealing, or market-making services in its home member state may "enjoy the full range of trading privileges normally reserved to members of the stock exchanges and organized securities markets" of the host country.[223]

To meet this obligation, a host state is required to ensure that such an investment firm has the option to become a member of the host country's stock exchange or organized securities markets by setting up branches or subsidiaries in the host state or by the acquisition of an existing member firm. Similarly, a host state is required to ensure that an investment firm that is authorized to deal in financial futures and options in its home member state may enjoy the full range of trading facilities on financial futures and options exchanges.[224]

The liberalizing provisions with regard to access to securities markets and exchanges do not cover credit institutions.[225] For these institutions, the policy remains one of national treatment. Thus if a host member state does not allow its own credit institutions to be members of such markets or exchanges, it is not obligated to admit a

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223 Id., art. 10.

224 Id.

225 See supra Section III.A.

branch of a credit institution chartered in another Community country even though the credit institution is a member of a market or exchange in its home state.[226] In order to become a member of securities markets or exchanges in the host state, such a credit institution could establish a subsidiary investment firm in the host country or acquire an existing member.[227] Alternatively, a credit institution could establish or acquire an investment firm in any EC country and gain access to an exchange in another member state through a branch of that firm.

The provisions for access in the proposed investment services directive do not address the question of access to host-country clearing facilities.

<u>Powers of the Commission</u>. As is the case under the proposed Second Banking Directive, the Commission is given discretionary power, subject to the approval of a committee of representatives from the member states, to expand the list of activities and to modify the areas in which the supervisory authorities are required to exchange information.[228] The same procedure would be used for the exercise of the Commission's discretionary powers under the reciprocity provision.

<u>Reciprocity</u>. As of this writing, the proposed Investment Services Directive contains a reciprocity provision similar to the original reciprocity provision in the proposed Second Banking

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[226] Proposed Investment Services Directive, art. 10.

[227] <u>Id</u>., explanatory memorandum, p. 7.

[228] <u>Id</u>., art. 20.

Directive.[229] However, it is expected that the Commission's revised proposals for reciprocity for banking services will become the model for the reciprocity provisions in the other financial services directives.

As is the case for direct branches of non-EC banks under the Second Banking Directive, direct branches of non-EC investment firms would not benefit from the expanded powers, the removal of host-country regulatory requirements, or, perhaps most important, the guaranteed access to markets and exchanges provided by the Investment Services Directive. Such branches would not be subject to an EC reciprocity requirement. However, they would be subject to any reciprocity requirements imposed by the individual member states. The proposed Investment Services Directive contains a provision parallel to that in the First Banking Directive which precludes a member state from granting more favorable treatment to the branch of a non-EC investment firm than it grants to branches of investment firms from other EC countries.[230]

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[229] Id., art. 6.

[230] Id., art. 5.

APPENDIX C: SECURITIES MARKETS

The EC program with regard to securities markets has been underway since the early 1980s and a number of directives have already been enacted. As noted in Section II.B. above, these directives as well as those that have been proposed but not yet enacted, are designed to break down barriers between national stock exchanges by both increasing transparency and ensuring access for issuers to securities markets throughout the Community. To this end, the directives provide for standardization of essential requirements and, in some areas, for mutual recognition of the equivalence and validity of national rules and practices that have not been harmonized. Two of the directives also provide for the possibility of negotiations to achieve mutual recognition vis-à-vis non-EC countries.[231]

In contrast to the United States, where all securities that are registered for sale to the public are subject to the same SEC disclosure requirements regardless of whether the securities are to be listed on a stock exchange (and thus subject to some additional requirements), in most of the EC countries registration is a negligible step and the emphasis is on requirements associated with stock exchange listing. Partly as a result of this situation, the EC directives deal with disclosure requirements for listed and unlisted securities separately. Until recently, the directives adopted by the Council had focused on listed securities; however, a directive adopted at the end of 1988 deals

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[231] See supra Section III.B.

with disclosure requirements for securities that are publicly traded but not listed on a stock exchange.

Directives relating to listed securities. The initial group of directives dealt with harmonization of rules associated with listing of securities on stock exchanges. These directives, which were implemented simultaneously in mid-1983, were not based on the principal of mutual recognition. However, a later amendment provided for mutual recognition of information disclosure requirements among the member states.

The first of these directives, which was adopted in 1979, represented a partial step toward harmonization of minimum standards that securities must meet in order to be listed on a stock exchange within the Community.[232] However, the harmonization provided by the directive was not considered sufficient to guarantee that Community issuers whose securities meet these standards would have an automatic right to be listed. As a result, a member state, subject to certain limitations, is allowed to impose more stringent requirements for securities to be listed on its exchanges.[233] (The directive applies to any securities listed on

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232 Council Directive of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing (79/279/EEC) [hereinafter Admission of Securities Directive] 22 O.J. Eur. Comm. (No. L 66) 21 (1979); Council Directive of 3 March 1982 amending Directive 79/279/EEC coordinating the conditions for the admission of securities to official stock exchange listing and Directive 80/390/EEC coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing (82/148/EEC), 25 O.J. Eur. Comm. (No. L 62) 22 (1982).

233 Admission of Securities Directive, art. 5. A member state may not require that securities must already be listed in another member state. Id., art. 6. With regard to securities of non-EC issuers, however, a member state may require such securities to be listed in the country of origin or the country in which a major proportion of the shares are held. Id., Annex, Schedule A.

EC exchanges, including those of non-EC issuers.)

The second directive, which was adopted in 1980, provided for harmonization of "listing particulars" (i.e., the prospectus and any other information to be publicly disclosed) for admission of securities to stock exchanges.[234] Under this directive, member states were required to ensure that, at a minimum, the information set forth in the directive would be published. A third directive, adopted in 1982, dealt with information that must be published on a regular basis by any company that is listed on a stock exchange within the Community.[235]

In a situation involving simultaneous admission to stock exchanges in several member states, the original listing particulars directive provided only that the authorities "use their best endeavors to achieve maximum coordination."[236] By contrast, a 1987 amendment to the directive provides for mutual recognition of home-country information disclosure requirements (all of which would, of course, be at least as strict as the minimum required by the directive) among the member

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[234] Council Directive of 17 March 1980 coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing (80/390/EEC) [hereinafter Listing Particulars Directive] 23 O.J. Eur. Comm. (No. L 100) 1 (1980); Council Directive of 3 March 1982 amending Directive 79/279/EEC coordinating the conditions for the admission of securities to official stock exchange listing and Directive 80/390/EEC coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing (82/148/EEC), 25 O.J. Eur. Comm. (No. L 62) 22 (1982).

[235] Council Directive of 15 February 1982 on information to be published on a regular basis by companies the shares of which have been admitted to official stock-exchange listing (82/121/EEC), 25 O.J. Eur. Comm. (No. L 48) 26 (1982).

[236] Listing Particulars Directive, art. 10.

states.[237] The amendment will become effective at the beginning of 1990 for all of the member states except Spain and Portugal.[238] In contrast to the banking and investment services directives, the 1987 amendment to the listing particulars directive explicitly provides for the possibility of the Community entering into mutual recognition agreements with non-EC countries.[239]

In December 1988, the Council took final action on an additional directive dealing with disclosure rules for large shareholdings in a company listed on an EC stock exchange.[240] Under the EC directive, upon acquisition or disposal of shares, an ownership interest in a company listed on a stock exchange must be disclosed by a shareholder when that interest reaches or falls below certain thresholds, the first of which is

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[237] See supra note 84. In a simultaneous admission situation, the listing particulars are to be drawn up in accordance with the EC directives in the member state in which the issuer has its registered office and approved by the authorities in that member state. The listing particulars must then be recognized by the other member states. If the registered office of the issuer is in a country outside the Community, the issuer must choose one of the member states under whose regulatory and supervisory authority the listing particulars will be published. Mutual Recognition Amendment to Listing Particulars Directive, art. 24.

[238] Id., art. 2.

[239] Id., preamble, art. 25a. See also supra Section III.B.

[240] Council Directive of 12 December 1988 on the information to be published when a major holding in a listed company is acquired or disposed of (88/627/EEC) [hereinafter Large Shareholdings Disclosure Directive], 31 O.J. Eur. Comm. (No. L 348) 62 (1988). See also Commission of the European Communities, "Proposal for a Council Directive on information to be published when major holdings in the capital of a listed company are acquired or disposed of" [hereinafter Proposal for a Large Shareholdings Disclosure Directive] COM(85) 791 final (December 23, 1985), explanatory memorandum.

set at 10 percent of the voting shares.[241] The disclosure requirements for large shareholdings do not apply to listed companies from non-EC countries because, without equivalent provisions in the home country, such companies would not be able to comply.[242]

Directive relating to unlisted securities. Rules regarding the prospectus to be published when transferable securities that are not already listed on a stock exchange are offered to the public for the first time are dealt with in a directive that was adopted by the Council in December 1988.[243] The directive provides for harmonization of minimum requirements relating to the publishing, scrutiny, and distribution of prospectuses for initial public offerings and for mutual recognition of prospectuses among the member states. The directive contains a provision similar to that in the 1987 listing particulars directive that permits the Community to enter into mutual recognition agreements with non-EC countries.[244]

At the insistence of the United Kingdom and Luxembourg, the directive exempts all transferable Eurosecurities that are "not the subject of a generalized campaign of advertising or canvassing" from its

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[241] The other thresholds are 20 percent, 33-1/3 percent, 50 percent, and 66-2/3 percent. Large Shareholdings Disclosure Directive, art. 4. The shareholder must disclose the information to the governmental authorities and to the company, which must in turn disclose the information to the public. Id, arts. 4 and 10. Exemptions are provided for professional dealers in securities. Id., art. 9. In addition, upon entry into force of the directive, there is a one-time disclosure requirement for all ownership interests of 10 percent or more. Id., art. 5.

[242] Proposal for a Large Shareholdings Disclosure Directive, explanatory memorandum, p. 4.

[243] See supra note 85.

[244] Mutual Recognition of Prospectuses Directive, art. 24.

requirements.[245] The rationale for the exemption was that Eurosecurities are generally dealt with by institutional investors who do not require the same level of protection as individual investors. Because Eurobonds are often marketed at short notice and for short periods of time, there was considerable concern that, if Eurobonds had not been exempted, the business would have been driven out of the Community.

Other measures regarding securities markets. The Commission has put forward a proposal regarding insider trading, which has not yet been considered by the Council.[246] The Commission has also issued a recommendation that relates to a European code of conduct for securities transactions.[247] Although the 1985 White Paper included a discussion of creation of an electronically linked Community-wide trading system for securities of international interest, no specific proposals have been put forward.

UCITS. An EC directive regarding cross-border sales of one particular securities product, namely, unit trusts or "undertakings for collective investment in transferable securities" (UCITS), will become effective in October 1989.[248] At that time, a UCITS that is authorized in a member state in accordance with the basic standards for investor protection set forth in the directive may be sold throughout the

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245 Id., art. 2.

246 Commission of the European Communities, Amendment to the Proposal for a Council Directive Coordinating Regulations on Insider Trading, COM(88) 549 final (October 4, 1988), 31 O.J. Eur. Comm. (No. C 277) 13 (1988).

247 Commission Recommendation of 25 July 1977 concerning a European code of conduct relating to transactions in transferable securities (77/534/EEC), 20 O.J. Eur. Comm. (No. L 212) 37 (1977).

248 See supra note 86.

Community under home-country control. Even if standards are more stringent in the country of the customer, such standards may be applied only to UCITS headquartered in that country. The country of the customer is not permitted to require any additional authorizations for UCITS authorized in other member states or to require that the sale be conducted through a branch.

Because the UCITS directive does not attempt to harmonize national marketing and advertising restrictions, these areas remain under host-country control.[249] Thus individual member states may continue to impose their own rules with regard to marketing and advertising, provided, of course, such rules are applied on a national treatment basis and can be justified on the basis of the public interest test. To date, there have not been any proposals regarding harmonization of tax treatment of unit trusts within the Community. As a result, upon implementation of the directive, unit trusts marketed by undertakings located in Luxembourg, which will continue to benefit from tax treatment more liberal than that in other member states, may be be sold throughout the Community.

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[249] UCITS Directive, art. 44.

APPENDIX D: INSURANCE

In contrast to the banking and securities sector, the insurance industry in the European Community, with the exception of the United Kingdom, has been relatively protected from outside competition and has not been part of any globalization process. Reinsurance, which has traditionally been an international business, is the exception. In general, the member states have imposed a multitude of restrictions on insurance services provided through branches or agencies and on services provided across borders. For example, most of the EC countries require life insurance companies to set up subsidiaries in order to conduct business with host-country residents, and six of the member states either prohibit or require special approval for insurance policies in foreign currencies.[250] In general, the United Kingdom is the only member state in which foreign life insurance companies are allowed to compete freely, that is, without being required to establish a subsidiary as well as without being subject to any restriction on the currency in which the contract is denominated.[251]

Partly because of the multitude of existing barriers, the extent of harmonization adopted or proposed by the European Community in the area of insurance is considerably less than that in the areas of banking and investment services. One result is that in the area of insurance, to date the European Community has continued to adhere to the more traditional conceptual grouping of provision of services, that is, those

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[250] Bureau Européen des Unions de Consommateurs, Term Insurance in Europe, Report no. 51/88, pp. 7-8 (Brussels: BUEC, March 1988).

[251] Id.

provided through branches and subsidiaries and those provided across borders.[252] In contrast to the banking and investment services directives, the insurance directives adopted or proposed in 1988 deal only with cross-border provision of services and do not provide for Community-wide branching under home-country control. Moreover, also unlike the other financial services directives, the insurance directives provide for home-country control only for wholesale customers who are deemed not to require the same degree of protection that is considered necessary for less sophisticated customers.[253]

Branches, agencies, and subsidiaries of insurance companies. Conditions for establishment of branches, agencies, and subsidiaries in other member states were addressed by EC legislation in the 1970s. The First Non-life Insurance Directive, adopted in 1973,[254] and the First Life Insurance Directive, adopted in 1979,[255] were designed to harmonize general conditions governing the business of insurance in the member states and to facilitate the establishment of branches and agencies in other member states by abolishing various restrictions. Under these directives, branches and agencies of insurance companies are subject to host-country control with regard to authorization and other requirements,

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[252] See supra Section III.A.

[253] However, the exemption for Eurosecurities in the directive relating to prospectuses for public offerings was in part justified by distinguishing between the amount of information required by large institutional investors and that required by individual investors. See supra Appendix C.

[254] See supra note 138.

[255] See id.

although the home country does have responsibility for ensuring the firm's overall solvency.

With regard to non-EC insurance companies, the directives require such a company to establish an agency or branch in each country in which it conducts business.[256] As discussed in Section III.B above, although there is no reciprocity requirement for agencies or branches of non-EC insurance companies, the directive sets forth solvency and other requirements for such offices that are more onerous than those applicable to agencies and branches of EC insurance companies.

Coinsurance. In 1978, the Community also adopted a directive relating to the provision of one particular type of insurance, coinsurance, which involves joint participation in coverage by more than one insurance company.[257] Coinsurance, which is not widely used in the United States, is necessary in a situation where insurance companies are relatively small and thus less able to cover large risks themselves and where reinsurance is not readily available. The EC directive removes barriers to coinsurance activities within the Community by providing that an insurer's right to participate in Community coinsurance (i.e, coinsurance in which the risk is located within the Community) may not be made subject to any other provision than those in the directive[258] and by

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[256] First non-life Insurance Directive, art. 23; First Life Insurance Directive, art. 27.

[257] Council Directive of 30 May 1978 on the coordination of laws, regulations and administrative provisions relating to Community co-insurance (78/473/EEC), 21 O.J. Eur. Comm. 25 (1978). This directive does not apply to life insurance.

[258] Id., art. 3.

specifying that, except with respect to technical reserves, the rules of the country of the leading insurer apply to the transaction.

Cross-border provision of insurance services. In June 1988, the Council adopted a non-life insurance directive based on the principles of mutual recognition and home-country control, but only for certain policyholders deemed not to require the high degree of protection inherent in host-country control.[259] In December 1988, the Commission proposed similar directives in the area of life insurance[260] and motor vehicle liability insurance.[261] A second stage of additional harmonization is considered necessary before the principle of home-country control can be applied more broadly to all types of policyholders.[262]

These directives, in contrast to proposed Second Banking Directive and the proposed Investment Services Directive, deal only with the cross-border provision of services and do not provide for Community-wide branching under home-country control. Branches of insurance

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259 See supra note 88. For these policyholders, rules regarding policy conditions and premium rates are determined by the home country; the host country is not permitted to require approval of such conditions or rates. Second Non-life Insurance Directive, art. 18. Similarly, home-state rather than host-state authorities have responsibility for supervision of technical reserves. Id., art. 23.

260 See supra note 88. The proposed directive relates only to individual contracts that are not connected with a business activity. Group insurance plans are not covered by the directive; the Commission expects to propose a separate directive in this area. Proposed Second Life Insurance Directive, explanatory memorandum, pp. 3, 10.

261 See supra note 90. Motor vehicle liability insurance had not previously been included within the scope of the non-life insurance directives.

262 Proposed Second Life Insurance Directive, explanatory memorandum, p.4.

companies will continue to operate under provisions for host-country authorization and regulation in the earlier directives. However, branches, as well as the head-offices, of EC insurance companies may benefit from the liberalizing provisions for cross-border services in the directives proposed or adopted in 1988.[263]

In determining whether host-country rules could be applied to the cross-border provision of insurance services, the European Court of Justice considered the degree of protection required by policyholders and insured persons and distinguished between the needs of small policyholders and those of large, commercial risks.[264] The insurance directives adopted or proposed in 1988 use such distinctions to determine whether home- or host-country control will apply. The non-life insurance and motor vehicle insurance directives distinguish between "large risks" (defined primarily in terms of the number of employees, sales, and assets of the policyholder[265]) and "mass risks." Similarly, the life insurance directive distinguishes between those who take the initiative in seeking life insurance from a company in another member state and

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[263] Second Non-life Insurance Directive, arts, 2, 12; proposed Second Life Insurance Directive, arts. 2, 10. However, direct branches of non-EC insurance companies are not permitted to benefit from the liberalizing provisions with respect to cross-border services. Second Non-life Insurance Directive, art. 2; proposed Second Life Insurance Directive, art. 2, explanatory memorandum, p. 5. See also supra Section III.B.

[264] See supra Section III.A.

[265] Certain classes of risks are also considered "large risks" without regard to these criteria. Second Non-life Insurance Directive, art. 5. See also proposed Motor Vehicle Liability Insurance Directive, arts. 2, 3; proposed Second Life Insurance Directive, explanatory memorandum, p. 2.

those who do not take such an initiative.[266] The directives apply the principle of home-country control only to the "large risks" and to those individuals who take the initiative in purchasing life insurance across borders. The rationale is that these categories of policyholders have adequate knowledge to be able to buy insurance that is regulated and supervised only by the insurer's home country.

Reciprocity. With regard to EC insurance subsidiaries of non-EC firms, the non-life insurance directive adopted in June 1988 did not contain a reciprocity clause. However, the life insurance directive proposed by the Commission in December 1988 contains a reciprocity provision similar to the original provision in the proposed Second Banking Directive and in the proposed Investment Services Directive.[267] Reportedly, the Commission plans to propose an amendment to the June insurance directive that would contain a reciprocity provision. It is expected that the reciprocity provisions in the insurance directives will ultimately be modeled on the revised reciprocity provision recently put forward by the Commission for the proposed Second Banking Directive.

From a U.S. point of view, the application of an EC reciprocity provision in insurance could, at least in theory, be more complicated than in banking. Although in the banking sector some issues could be

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[266] The policyholder is deemed to have taken the initiative if (1) the initial contact is made by the policyholder or (2) the contract is concluded in the insurance company's home state without any prior contact in the policyholder's state of residence. Advertising in the policyholder's state of residence is prohibited, and the role of a broker is strictly limited. In addition, the policyholder is required to sign a statement acknowledging that the rules of the company's home state apply. Proposed Second Life Insurance Directive, art. 13, explanatory memorandum, pp. 3-4.

[267] Id., art. 9.

raised by state treatment of foreign banks under the operation of the dual banking system, there is an overall Federal statutory framework and a Federal policy of national treatment. The regulatory framework for the insurance industry is very different. Under the McCarran-Ferguson Act, the business of insurance is to be regulated by the states to the extent that it is not specifically regulated by the United States.[268] As a result, entry and operation of foreign insurance companies is controlled by the individual states, not by the Federal government. While most states permit foreign insurance companies to enter through either a branch or a subsidiary, authorization and other requirements differ among the states. It seems likely, however, that the European Community would make an overall (as opposed to a state-by-state) determination regarding the treatment of EC insurance companies by the United States.

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[268] 15 U.S.C. § 1012 (1982).

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