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**The Development of the EU Regulatory and
Supervisory Framework applicable to
UCITS: A Critical Examination of the
Conditions and Limitations of Mutual
Recognition**

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DPhil in Law

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March 2014

I hereby declare that this thesis has not been and will not be, submitted to another University for the award of any other degree.

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The Development of the EU Regulatory and Supervisory Framework applicable to UCITS: A Critical Examination of the Conditions and Limitations of Mutual Recognition

SUMMARY

The thesis examines the conditions and limitations of mutual recognition and seeks to identify the *lacunae* in the governance mechanism and the regulatory framework applicable to undertakings in collective investment in transferable securities ('UCITS'). It assesses the regulatory and supervisory mechanisms that may be applied to address the identified weaknesses. For this purpose, the thesis formulates a theoretical framework for effective mutual recognition based on *quasi*-maximum harmonisation, reflexive governance of financial supervision and a mechanism for the strengthening of mutual trust between national financial supervisors.

The technique for financial regulation in the field of UCITS should create the right balance between implementing a policy designed to attain a high degree of harmonisation of investor protection regulation and making exceptions to address national differences. The picture that emerges is one where a model based on minimum harmonisation causes serious limitations to mutual recognition in the form of inconsistencies in the implementation of EU Law and the application of national discretions. *Quasi*-maximum harmonisation becomes the optimal technique for UCITS. However, the limitations of a model based on minimum harmonisation of regulation resurface, although to a lesser extent, even in a framework based on *quasi*-maximum harmonisation.

The solution is not one where an even higher degree of harmonisation (the single rulebook mechanism) is required, but lies in reflexive governance of financial supervision combined with a framework for the strengthening of mutual trust between national financial supervisors. This framework can form the basis for overcoming the remaining obstacles to the cross-border activity of UCITS, including the barrier to the depositary passport which is the last major bastion that stands in the way of a complete internal market for UCITS.

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List of Abbreviations

AIFMD	Alternative Investment Fund Managers Directive
AIF	Alternative Investment Fund
ALFI	Association of the Luxembourg Fund Industry
AMF	Autorite Des Marche Financiers – French Financial Markets Authority
BAFIN	Bundesanstalt für Finanzdienstleistungsaufsicht - German Federal Financial Regulator
BCBS	Basel Committee of Banking Supervision
BCCI	Bank of Credit and Commerce International
BIS	Bank of International Settlements
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CEPS	Centre for European Policy Studies
CESR	Committee of European Securities Regulators
CFPB	Bureau of Consumer Financial Protection
CJEU	Court of Justice of the EU
CONSOB	Commissione Nazionale per le Società e la Borsa – Italian Securities Regulator
CMVM	Comissão do Mercado de Valores Mobiliários – Portuguese Securities Regulator
CNMV	Comisión Nacional del Mercado de Valores – Spanish Securities Regulator
CNVM	Comisia Națională a Valorilor Mobiliare – Romanian Securities Regulator
CRD	Capital Requirements Directive
CRD IV	Fourth Capital Requirements Directive
CSSF	Commission de Surveillance Secteur Financier – Luxembourg Financial Regulator
CCP	Central Counterparty Party

EBA	European Banking Authority
EBF	European Banking Federation
ECB	European Central Bank
ECJ	European Court of Justice
EFAMA	European Fund and Asset Management Association
EMIR	European Markets Infrastructure Regulation
EIOPA	European Insurance and Occupational Pensions Authority
ESMA	European Securities and Markets Authority
ESC	European Securities Committee
ESRB	European Systemic Risk Board
ETF	Exchange Traded Fund
EU	European Union
FCA	UK Financial Conduct Authority
FSAP	Financial Services Action Plan
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
IMF	International Monetary Fund
IMF FSAP	Financial Sector Assessment Program
IAA 1940	Investment Advisers Act of 1940
IAIS	International Association of Insurance Supervisors
ICA 1940	Investment Companies Act of 1940
ICI	Investment Company Institute
IOSCO	International Organisation of Securities Commissions
KIID	Key Investor Information Document
LTCM	Long Term Capital Management LP

MAD	Market Abuse Directive
MiFID	Markets in Financial Instruments Directive
MiFID II	Commission Proposal for a Revision of the Markets in Financial Instruments Directive
MMF	Money Market Fund
OTC	Over the Counter
OECD	Organisation for Economic Co-operation and Development
PD	Prospectus Directive
SEC	Securities and Exchange Commission
SSM	Single Supervisory Mechanism
TD	Transparency Directive
TEC	Treaty Establishing the European Community
TFEU	Treaty on the Functioning of the EU
UCITS	Undertakings for Collective Investment in Transferable Securities
US	United States of America

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A2) United States

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B) Legislation

B1) European Union

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Chapter 1

INTRODUCTION, HYPOTHESIS, METHODOLOGY AND CHAPTER OUTLINE

1.1 Introduction and Hypothesis

Mutual recognition is an essential governance tool for the conduct of international trade and has the basic function of giving effect to the regulatory requirements of the home jurisdiction in the host jurisdiction. Mutual recognition is contingent on the relations between jurisdictions and the trust that these have in the regulatory framework and the supervisory capabilities of one another. It is a governance mechanism that has been broadly based on the compatibility and acceptance of a counterpart's regulatory and supervisory system. Mutual recognition has been extensively applied for the purpose of the construction of an internal market in the field of financial services.

The conditions for mutual recognition have been and are still evolving. The 1985 Cockfield formula based mutual recognition on a combination of minimum harmonisation of regulation, home country control and complementary host country supervision. A new formula was prescribed by the 2001 Lamfalussy Process which based mutual recognition on the realisation of a higher degree of harmonisation of EU financial regulation, in the context of the Undertakings for Collective Investment in Transferable Securities ('UCITS') Directive achieving *quasi*-maximum harmonisation, the consistent implementation and application of EU regulation by Member States, and the convergence of supervisory practices through cooperation between financial supervisors.

Quasi-maximum harmonisation is a technique which brings together and calibrates minimum and maximum harmonisation provisions. While maximum harmonisation is applied in those instances where complete homogeneity and consistency are required to achieve a high degree of investor protection, minimum harmonisation is applied to those areas of regulation where flexibility is required in order to respect the distinct legal traditions and cultural differences at national level.

In the first instance the application of maximum harmonisation generally suggests that mutual recognition would not remain relevant to that specific area of regulation, as this is applicable across the EU on the basis of a single regulatory framework. However, when considered within the context of the functioning of the internal market in a field of regulation where maximum and minimum harmonisation of regulation coexist, instances of maximum harmonisation become a mechanism for the strengthening of the overall mutual recognition between Member States, as it reinforces mutual trust between these States in areas which are exceptionally important for accomplishing the objectives of financial regulation.

The financial crisis and the resulting failures of cross-border financial institutions, brought to bear the limitations of a system based on Lamfalussy tools for mutual recognition. The application of Lamfalussy Directives became synonymous with differences in the interpretation and application of the EU regulatory framework that resulted in regulatory arbitrage which weakened the integrity and stability of the EU financial system. Similarly, in the field of financial supervision the adherence to national agendas resulted in lack of cooperation, and inconsistency in financial supervision. During the financial crisis, this state of affairs resulted in what Jacques DeLarosi re described as *chacun pour soi* solutions, aimed at safeguarding the national interest. This attitude weakened the effectiveness of the internal market mechanisms based on mutual recognition as a particular action in one Member State could have a detrimental effect in other Member States.

In an attempt to address these concerns, governance mechanisms for regulation and supervision of the internal market were proposed by policy-makers, including the adoption of a European single rulebook for financial services; the application in certain instances of a centralised system for European supervision; the establishment of a European handbook for supervision; and the creation of colleges of financial supervisors for cross-border financial institutions. Such governance mechanisms have been applied in different doses to the main areas of EU financial regulation and supervision.

The UCITS Directive, which regulates and creates an internal market for the European collective investment scheme industry that primarily targets retail investors, is one of the

remaining pieces of EU law which, to a large extent, still operates on the basis of mutual recognition. While other major pieces of EU regulation, such as the Markets in Financial Instruments Directive¹ ('MiFID'), Market Abuse Directive² ('MAD'), and the Capital Requirements Directive³ ('CRD'), have been or are in the process of being transformed into single/partial single rulebook type legislative frameworks, the governance mechanism for regulation and supervision under the UCITS Directive has remained largely untouched.

The UCITS Directive was adopted by the Council in 1985.⁴ The main objective of the 1985 UCITS Directive was that of attaining a minimum degree of harmonisation of EU regulation of collective investment schemes that would have allowed mutual recognition to operate in this field. It aimed at achieving a homogenous degree of retail investor protection within Europe through product regulation such as the application of diversification requirements and transparency regulation. Since 1985, various proposals for the reform of the substantive requirements applicable to UCITS have been made by the Commission. Some of these proposals, such as the application of a passport for depositaries of UCITS, proved to be controversial, have continuously been rejected by policy-makers and are still the subject of on-going policy debate.

In 1993 the Commission proposed the extension of the scope of the UCITS Directive to a wider selection of funds.⁵ The UCITS II proposal also provided for the introduction of UCITS master-feeder structures and the creation of an internal market for depositaries. These proposals were considered as too ambitious and controversial by the Member States and brought negotiations in the Council to a halt.⁶ In 1998, the Commission published a new proposal⁷, which was adopted in 2001 in the form of two Directives⁸.

¹ Directive 2004/34/EC.

² Directive 2003/3/EC.

³ Directive 2006/48/EC and Directive 2006/49/EC repealed and replaced by Regulation (EU) No575/2013 and Directive 2013/36/EU.

⁴ Directive 85/611/EC.

⁵ Commission, Proposal for a Directive amending Directive 85/611/EEC, Com(93)37, 09.02.93 'Amended proposal for Directive amending Directive 85/611/EEC', COM(94)329 20.07.94 <<http://goo.gl/cMcOCa>>accessed 05.02.11.

⁶ J Benjamin and A Holmes, 'The Evolving Legal Environment for Fund Management' (1996) 10 Journal of International Banking and Financial Law 480

⁷ Commission, 'Proposal for a Directive amending Directive 85/611/EEC', COM(1998)449, 17.07.98 and 'Proposal for a Directive amending Directive 85/611/EEC', COM(1998)451, 17.07.98 <<http://goo.gl/tnV5Iz>>accessed 05.02.11.

⁸ Directive 2001/107/EC and Directive 2001/108/EC.

The 2001 UCITS III Directives widened the scope of the 1985 UCITS Directive to include other types of funds within the meaning of UCITS. The amendments also provided for a UCITS management company passport, which eventually proved to be ineffective. It also established a common framework for the application of a simplified prospectus, which in due course was deemed to be a failure.

In 2009, the UCITS Directive was recast and a new Directive was adopted. This is generally referred to as the UCITS IV Directive⁹. The recast Directive introduces various changes to the UCITS framework, such as the establishment of an effective management company passport, which became applicable on the 1st July, 2011. The 2009 UCITS IV Directive is now in the process of being amended by the Commission's 2012 UCITS V Proposal.¹⁰ This is a proposal to regulate the remuneration of managers of UCITS and to tighten up the requirements that regulate the activity of depositaries of UCITS.

In 2011 the EU also adopted the Alternative Investment Fund Managers Directive¹¹ ('AIFMD'), which regulates the management companies of alternative investment funds (AIF). This Directive was one of the measures adopted in response to the 2007-2008 financial crisis.¹² While both the UCITS Directive and the AIFMD seek to regulate the investment management industry and to create an internal market in this field, the specific segments of the industry covered by these Directives is different. The definition of an AIF is wide and captures all those funds which do not qualify as UCITS under the UCITS Directive, these may include hedge funds and private equity funds. The target market of AIFs is different from that of UCITS, as AIFs are generally offered as an investment to professional investors. Given the target market of AIFs and the wide definition given to this category of collective investment scheme, these type of funds are not subject to specific product regulation under the AIFMD, such as the specific diversification rules that apply to UCITS in terms of the UCITS Directive and which are crucial for the protection of retail investors.

⁹ Directive 2009/65/EC.

¹⁰ Commission, 'Proposal for a Directive amending Directive 2009/65/EC as regards, depositary functions, remuneration and sanctions' COM(2012)350<<http://goo.gl/bvWJxi>>; On 25.02.14 the Greek Presidency reached political agreement with the European Parliament on UCITS V Directive <<http://goo.gl/PH14wW>>accessed 28.02.14.

¹¹ Directive 2011/61/EC.

¹² E Ferran, 'After the crisis: the regulation of hedge funds and private equity in the EU' (2011) 12(3) European Business Organisation Law Review 379-414.

The difference between the two regimes also extends to the scope of regulation. While the UCITS Directive regulates both the product and the management company, the scope of the AIFMD is limited to the management company. The main reason for the EU's focus on the management company with respect to funds which are targeted to professional investors, is that the risks associated with these type of funds lie almost exclusively at the level of the management company, where all the decisions are made.¹³ It is noteworthy that the same approach to regulation of the investment management industry has, by and large, also been adopted in the US, where the regulation of retail type funds extends to both the product in terms of the Investment Company Act 1940, and the management company (in the US referred to as the investment adviser) in terms of the Investment Advisors Act 1940, while the regulation of professional funds is limited to the management company in terms of the latter Act.¹⁴

Nonetheless, in Europe this difference in approach between the retail and the professional segments of the industry is slowly changing, as the EU has in recent years embarked in the extension of product regulation to professional type funds such as venture capital funds¹⁵ and social funds¹⁶. Indeed, product regulation in the EU is still a work progress. In this regard, as evidenced by the 2012 UCITS VI Consultation¹⁷, the UCITS internal market project is far from being concluded. This document asked for stakeholders' views on the operation of the UCITS with regard to the assets which are eligible as investments for UCITS, the lack of an internal market passport for depositaries, and the regulation of other aspects of the operation and investment by certain types of UCITS. It also elicited opinions on whether the requirements regarding consolidation mechanisms and the passporting mechanism for UCITS might require improvement.

In addition, a number of other areas of UCITS raise additional regulatory and supervisory concerns. Significantly, the competition between Member States to attract financial

¹³ Commission, 'Impact Assessment: Proposal for an Alternative Investment Fund Managers Directive' SEC(2009)576, 30.04.09<<http://goo.gl/zTt1ej>>accessed 28.02.14.

¹⁴ P Maris, 'The new architecture for hedge fund regulation: an assessment of the recent US and EU initiatives' (2012) 6(3) Law and Financial Markets Review 208-214; and W Kaal, 'Hedge Fund Manager Registration Under the Dodd-Frank Act' (2013) 50(1) San Diego Law Review.

¹⁵ Regulation (EU) No 345/2013.

¹⁶ Regulation (EU) No 346/2013.

¹⁷ Commission, 'Consultation: UCITS – Product Rules, Liquidity, Depositary, Money Market Funds, Long-term Investment' 26.07.12<<http://goo.gl/9a1JYD>>accessed 05.02.14

institutions to their jurisdiction for eventual cross-border marketing across the EU has, in certain instances, generated a race to the bottom.¹⁸ In the context of UCITS this has *inter alia* resulted in differences between Member States on the type of portfolio composition which is acceptable in terms of the UCITS Directive.

Post the financial crisis, EU policy-makers expressed the concern that fragmented regulation and supervision was leading to regulatory arbitrage and was providing incentives to financial supervisors to compete via lax supervision to avoid putting national industry in a less competitive position or out of fear that some institutions would shift part of their business to less strict regulatory systems.¹⁹ As a consequence, the emerging governance mechanism for EU financial regulation and supervision promotes a higher degree of centralisation at EU level.

Albeit, the regulation of UCITS still remains to a significant degree based on Directives which require transposition into national law and which grant Member States the opportunity to shape the implementing legislation to their particular circumstances. Moreover, the supervision of UCITS stands firmly at national level. A governance mechanism for financial regulation which is based on Directives and where financial supervision is carried out at national level requires a degree of mutual recognition between the Member States. This is particularly relevant given the different implementation and interpretation of the UCITS Directive at national level, and the fact that financial supervisors still embrace different supervisory philosophies and apply diverse practices and methods for monitoring compliance with the requirements applicable to UCITS, with minimum supervisory convergence if any.

The thesis argues that while a blend of European and national regulatory and supervisory mechanisms has been adequate for building the foundations of a broad internal market for UCITS, the incomplete substantive regulation of UCITS, the inconsistent implementation and interpretation of the UCITS Directive in order to further the national interest and the lack of proper supervisory convergence and cooperation, have resulted in opportunities

¹⁸ M Lamandini, 'Towards a New Architecture for European Banking Supervision' (2009) 6(1) European Company Law 6-13.

¹⁹ European Parliament, 'Working Document No3 on financial supervision and regulation – future model' Special Committee on the Financial, Economic and Social Crisis, 02.03.10; and 'To what extent did financial regulation and supervision fail in preventing the crisis?' February 2010<<http://goo.gl/fy0rMS>>accessed 05.09.12.

for regulatory arbitrage and for lax supervision. These have brought to light the limitations of mutual recognition based on harmonised regulation in achieving EU-wide governance in the field of financial services. These limitations generate tensions and mutual distrust between Member States and obstruct the further development of cross-border activity of UCITS within the internal market. The thesis identifies four specific regulatory and supervisory weaknesses that hinder the completion of the internal market for UCITS, being: **[i]** the inconsistent implementation and interpretation of the UCITS Directive; **[ii]** the application of national marketing rules; **[iii]** the lack of a depositary passport; and **[iv]** a failure to achieve supervisory convergence.

The thesis addresses the following key question: What are the governance mechanisms that may be applied to overcome the identified limitations of the regulatory and supervisory framework for mutual recognition in the field of UCITS?

The hypothesis of the thesis is that *quasi*-maximum harmonisation, a mixture of minimum harmonisation and maximum harmonisation, is the optimal harmonisation technique for UCITS, as it provides flexibility where this is necessary in order to respect the different legal traditions at national level. However, in view of the identified limitations and weakness, mutual recognition based on harmonisation *per se*, is not the best possible tool for removing the remaining regulatory and supervisory barriers to the cross-border activity of UCITS. The thesis contends that to overcome these barriers *quasi*-maximum harmonisation of regulation would have to be complemented by reflexive governance of financial supervision, that is built upon the mechanisms for cooperation and convergence established by EU policy-makers post the financial crisis, and combined with a mechanism for the strengthening of mutual trust between national financial supervisors.

Reflexive governance is a process that promotes learning from diversity. The over-all focus of the process is a continuous search for better approaches to address the governance problem. The constructive and valuable feature of a process of reflexivity in governance is that the outcome of the learning process bends back on the participants that have instigated and participated in the process. For reflexive governance to work, participants must be equipped to become active in the decision-making process and must be supported through *inter alia* institutional arrangements for cooperation and debate.

1.2 Aim, Methodology and Originality

This thesis seeks to identify the *lacunae* in the governance mechanism and the regulatory framework for mutual recognition in the context of the UCITS Directive and to propose mechanisms to address these deficiencies. For this purpose the thesis examines how the conditions for mutual recognition have evolved through the different stages in the development of the EU framework for the regulation and supervision of financial services, in particular in the context of the UCITS Directive. The thesis also analyses how the different conditions for mutual recognition have contributed to the overcoming of identified regulatory and supervisory obstacles to cross-border business of UCITS.

The thesis examines the regulatory and supervisory conditions that have caused, and in some instances are still bringing about, certain restrictions to the completion of the internal market for UCITS. It analyses the limitations of the governance mechanism and regulatory framework for mutual recognition. As part of the overall analysis carried out for the purpose of the thesis, the substantive regulations applicable to UCITS are considered. Examining the substance of regulation is important to determine the effect of legislation and the success of the framework in removing the barriers to cross-border activity.

The aims of the thesis have partly been fulfilled through an analytical consideration of academic articles, legal and policy documents and other relevant literature, which deal with different aspects of financial regulation and supervision in general and UCITS in particular. The analysis in the thesis has been written taking a historical approach. Analysing the history of the development of the governance mechanism and the regulatory framework for mutual recognition in the context of the UCITS Directive is relevant to understand the present position. The thesis attempts to place the historical material in the context of the current EU regulatory framework. In a number of instances the analysis also brings in a comparison between the EU and the US. In the US a sophisticated federal system of financial regulation and supervision of securities business

has been in place for over eighty years.²⁰ In this regard, the comparison is useful to obtain a sense of perspective. In particular, the comparison with the US allowed a deeper analysis of the evolution of the regulation of collective investment schemes and the future of regulation and supervision in the EU.

The analysis of the information obtained through the literature review, was complemented with evidence on the topic of the thesis obtained through interviews with policy-makers, financial supervisors and industry practitioners. For this purpose, a random sample of twenty-two participants was selected. The list of participants and the introductory e-mail and list of questions have respectively been included in annex 1 and annex 2. The aim of the interviews was that of gathering further evidence on the regulatory and supervisory barriers to cross-border activity of UCITS and their service providers and to assess the validity of any proposed solutions to overcome these barriers.

The evidence gained from the interviews served to inform the author on the mechanisms that may be applied to overcome the remaining limitations of the framework for mutual recognition in the field of UCITS and to identify the optimal mechanism in this regard. While the discussions held during the interviews are not specifically referenced in the thesis, citations of a general nature have been made in specific sections to acknowledge the contribution of the discussions held during the interviews to the stance taken in the thesis. The carrying out of interviews for the purpose of the dissertation required approval from the Ethics Review Committee of the University of Sussex, which was granted in November 2012.

The value of the thesis is that it re-examines mutual recognition based on harmonised regulation and mutual trust as one of the principal governance mechanisms for the construction of the internal market for financial services. It formulates a theoretical framework for effective mutual recognition based on quasi-maximum harmonisation, reflexive governance of financial supervision and a mechanism for the strengthening of mutual trust between national financial supervisors. This is the main contribution of the thesis to the existing literature. The theoretical framework is applied as a solution to the

²⁰ The Securities Act which marked the beginning of federal regulation of securities business was adopted in 1933. See A Dean 'Twenty-Five Years of Federal Securities Regulation by the Securities and Exchange Commission' (1959) 59(5) Columbia Law Review 697-747.

limitations of the current regulatory framework for mutual recognition in the field of UCITS. Another significant contribution of this thesis is that it places the historical material in the context of the current EU regulatory framework and applies the lessons of the past to identify the possible solutions for the future.

The thesis also contributes to the academic debate on the future of the UCITS Directive, which is one of the pillars of EU securities regulation. While this Directive has been given considerable attention from practitioners in the field of financial services, it has not been the subject of any sufficient degree of academic consideration and research. The UCITS Directive is a unique piece of EU legislation in the field of financial regulation as it combines financial product regulation with the regulation of the provision of financial services and attempts to create an internal market for both. Furthermore, the UCITS internal market framework remains incomplete and further proposals in this regard are yet to be made by the Commission.

Different sections of the thesis have been published in the journals entitled *ELSA Malta Law Review*, *Law and Financial Markets Review* and *Journal of Business Law*. Throughout the process that led to the development of the ideas for the purpose of the thesis, other research on financial regulation conducted by the author was published in the *Journal of Financial Regulation and Compliance* and *The Accountant*. These publications have been referenced in the bibliography.

1.3 Chapter Outline

The rest of the thesis is organised into five chapters as follows.

Chapter 2 identifies the main theories and primary objectives of financial regulation and examines their continued validity in the light of the financial crisis. It analyses the public and private interest theories of regulation and concludes by highlighting their validity in understanding the rationale behind the policy response to the financial crisis. The chapter also evaluates the objectives of financial regulation and argues that the financial crisis has strengthened the case for regulation to safeguard systemic stability, protect the investor and ensure that financial markets are fair, efficient and transparent. The analysis is important for establishing the context within which financial regulation and supervision

may be understood and for comprehending the forces that drive mutual recognition based on harmonised regulation.

In chapters 3, 4 and 5, the application of the concept of mutual recognition in the context of the regulation of UCITS is analysed. The three chapters examine the various combinations of governance mechanisms and substantive regulation, which were adopted in order to allow mutual recognition between Member States in this field.

Chapter 3 focuses on the first two decades of the UCITS Directive. During this period mutual recognition was contingent on minimum harmonisation of substantive regulation to achieve a uniform degree of protection for investors in UCITS and the application of the home country control and complementary host country supervisory principles.

The central argument of chapter 3 is that while the 1985 UCITS Directive was a necessary first step in the process for the development of an internal market for UCITS, the limitations of the governance mechanism for mutual recognition based on minimum harmonisation of regulation, in the form of inconsistent application of the Directive and the application of Member State discretions, raised barriers to the internal market for UCITS. In addition the first two decades of the 1985 UCITS Directive were also characterised by limitations of the regulatory mechanism for mutual recognition in the form of tight investment restrictions and the prohibition imposed on the management company and on the depositary from providing cross-border services.

Chapter 3 also contends that while the subsequent amendments to the 1985 UCITS Directive addressed some of the limitations to the regulatory mechanism for mutual recognition they however widened the limitation of the governance mechanism for mutual recognition, as different interpretations in the application of the UCITS Directive remained a prevalent characteristic of its implementation by Member States and their financial supervisors.

Chapter 4 analyses the nature and operation of the governance mechanisms applied under the Lamfalussy Process and the effectiveness of this process for the construction of the regulatory framework of the 2009 UCITS IV Directive.

The central argument of chapter 4 is that the Lamfalussy Process established the tools for the strengthening of mutual recognition between Member States and, by so doing, created the appropriate setting for the construction of a broader internal market in the field of UCITS. It is argued that a high degree of transparency and a wide inclusive debate on the proposed EU regulatory framework for UCITS, permitting both political and technical consideration to be made, created the right environment for the successful operation of the Lamfalussy hard-law making process in achieving *quasi*-maximum harmonisation in the context of the 2009 UCITS IV Directive. The chapter makes the point that these characteristics of the Lamfalussy Process complement each other and that unless each of these elements is allowed to operate effectively, the legislative process will lose on its efficiency.

Chapter 4 also examines the application of the open method of coordination under the Lamfalussy Process. The chapter makes the point that soft-law mechanisms are an effective method to attain a degree of flexibility which is necessary to keep up with developments in financial markets. However, the unenforceability of soft-law may create legal uncertainty that may put in danger part of the harmonisation process which, in turn, weakens mutual recognition between the Member States. Another limitation of the soft-law mechanism as applied in practice under the Lamfalussy Process is that it mainly focused on measures which sought to accomplish regulatory convergence with little or no efforts in the field of supervisory convergence. Chapter 4 also examines the ESMA framework and how this attempts to address these weaknesses.

Chapter 5 analyses the substantive regime set in the 2009 UCITS IV Directive and the manner in which this seeks to broaden the internal market for UCITS and the hard-law and soft-law tools used for this purpose. It analyses the manner in which the 2009 UCITS IV Directive achieves *quasi*-maximum harmonisation. The chapter also examines the governance mechanism for the supervision of UCITS.

The analysis in chapter 5 demonstrates that while *quasi*-maximum harmonisation of regulation has proved to be the optimal mechanism for the development of the harmonised regulatory framework for UCITS, the soft-law tools selected for the purpose of the 2009 UCITS IV Directive did not achieve the desired degree of regulatory convergence which in terms of the Lamfalussy Process is an essential ingredient for the

operation of mutual recognition. Moreover, no sufficient degree of supervisory cooperation and convergence was achieved as a result of the operation of the Lamfalussy Process in practice.

The central argument of the chapter is that in order to overcome the remaining regulatory and supervisory barriers to cross-border business in the field of UCITS, mutual recognition based on *quasi*-maximum harmonisation would have to be complemented with reflexive governance of financial supervision based on cooperation mechanisms for cross-border UCITS structures and mutual monitoring through peer reviews. These mechanisms may be applied as vehicles for experimentation and mutual learning and as a basis to create a framework for supervisory convergence.

Chapter 5 makes the point that the strengthening of mutual trust between financial supervisors is critical for the proper functioning of reflexive governance of financial supervision. The chapter examines the high-level governance principles of autonomy of financial supervision and accountability. It contends that mutual trust may be strengthened if the independence from political and industry influence as well as the accountability to democratically elected institutions and to peers are guaranteed through a regulatory framework for this purpose at EU level.

Chapter 6 makes some concluding remarks.

Chapter 2

AN EXAMINATION OF THE THEORIES AND OBJECTIVES OF FINANCIAL REGULATION POST THE 2007-2008 FINANCIAL CRISIS

2.1 Introduction

The main contribution of the thesis is that it formulates a theoretical framework for effective mutual recognition based on *quasi*-maximum harmonisation, reflexive governance of financial supervision and a mechanism for the strengthening of mutual trust between national financial supervisors. The theoretical framework is applied as a solution to the limitations of the current regulatory framework for mutual recognition in the field of UCITS. Another significant contribution of the thesis is that it places the historical material in the context of the current EU regulatory framework and applies the lessons of the past to identify the solutions for the future.

To comprehend the forces that drive mutual recognition based on financial regulation, it is essential to analyse the theoretical framework that accounts for the origins of and the rationale for regulation. It is also important to critically examine the continued validity of the objectives, which in practice the regulation of financial services aims to achieve and which are important for effective mutual recognition. Indeed, unless EU substantive regulation addresses properly the inefficiency of financial markets through the effective attainment of the objectives of financial regulation, regulatory and supervisory barriers would generally be raised at national level in order to ensure additional protection of the local financial system and investor community. Within this context, the achievement of the objectives of financial regulation, within an environment of harmonised regulation as well as regulatory and supervisory convergence, becomes a key tool to generate mutual trust between Member States and the proper operation of the internal market.

The aim of the chapter is to critically examine and comment on the continued validity of the theories and objectives of financial regulation in the light of the financial crisis and the post-crisis policy response. The main contention of the chapter is that the post-crisis policy response may be explained as a combination of factors that surface from the theories of regulation and that the causes of the financial crisis and the subsequent regulatory measures which have been proposed sustain the continued validity of the objectives of financial regulation. It is also argued that regulatory and supervisory action to realise a specific objective of financial regulation could, at times, generate tensions with and weaken the realisation of other regulatory and economic objectives. The chapter also demonstrates the difficulties that could surface in finding the right balance between achieving the objectives of financial regulation, while avoiding instances of over-regulation by respecting the principles of proportionality, subsidiarity and the fundamental rights of members of society.

In the context of the thesis, it is important at this early stage to comment on the distinction between regulation and supervision, which in certain instances are used interchangeably in literature but which are different and very specific functions. It is also important to understand the difference between micro and macro prudential supervision, which are two dissimilar but equally important categories of supervision.

Regulation may be defined as the act of making laws and rules including soft law, while supervision refers to the day-to-day action of supervisors – who often are also regulators - monitoring the implementation and application of the rules in specific cases and includes the authorisation, supervision *stricto sensu*, crisis management and the taking of enforcement action where specific breaches have been committed.¹ In the context of financial services both regulation and supervision should seek to achieve the high-level objectives of regulation which are examined in this chapter. These two functions are, however, distinct in nature and require specific technical skills if they are to be implemented correctly.

¹ R Lastra, 'Central Banking and Banking Regulation' (FMG London 1996) 108-144; E Wymeersch, 'The Future of Financial Regulation and Supervision in Europe', (2005) 42 Common Market Law Review 987-1010; E Wymeersch, 'Europe's New Financial Regulatory Bodies' (11.04.11) <<http://ssrn.com/abstract=1813811>>accessed 22.02.14; R Lastra, 'Defining forward-looking judgment-based supervision' (2013) 14(3/4) Journal of Banking Regulation 221-227.

The carrying out of supervision may be further categorised into micro and macro prudential supervision. Micro-prudential supervision is concerned about the stability of individual financial institutions and is largely conducted through the over-sight of the governance, compliance, capital structures and risk management of individual financial institutions. Macro-prudential supervision is interested in the safety and stability of the financial system as a whole and seeks to identify threats to systemic stability by analysing the trends and imbalances in the financial system.²

As further analysed in this chapter, micro and macro prudential supervision are generally carried out separately. Nonetheless, in the context of achieving the systemic stability objectives of regulation these two specific categories of supervision are equally fundamental and become mutually dependent on each other.

The rest of the chapter is divided into three other sections. The next section examines the public and private interest theories of regulation. The third section evaluates the objectives of financial regulation in the light of the causes which brought about the financial crisis and the regulatory tools devised by policy-makers in order to create order within the financial system. Some additional remarks on this topic are made in the concluding section.

2.2 Theories of Regulation

The development of market economies has been conditioned by the ideas of two main schools of thought, whose views are reflected in two systems of economic organisation, that is the market system and the collectivist system.

The market system, which, to a large extent is based on capitalist ideology, is characterised by market freedom, where individuals and in particular the industry, are subject to very simple controls and are otherwise uninhibited from pursuing their own welfare objectives.³ In a market system, the economy is supported by the legal order, particularly through instruments of private law which have a facilitative function by

² A Persaud, 'Macro-Prudential Regulation' in I MacNeil and J O'Brien (eds) *The Future of Financial Regulation* (Hart 2010) 437-445.

³ A Ogus, *Regulation: Legal Form and Economic Theory* (Hart 2004) 1.

offering a set of official arrangements through which the relationship between individuals is regulated and as a consequence of which they can conduct their activities and carry out their business. Consequences of a private law nature relate to, for example, the nullity of a contract and a counterparty's right to compensation or restitution. Private law is distinct from public law. The latter regulates the relationship between the general public and the State. Claims of a private law nature are usually brought before the civil courts, whereas public law, in the form of administrative regulatory requirements, is enforced by regulatory agencies such as financial supervisors.

In a market system private law is the means through which market failures can be addressed. State intervention through public law and the supervision of the market by a regulatory agency has only a minimal role to play, if any.

According to the collectivist system, private law is not enough to address all instances and forms of possible market failure. Therefore, public law and state intervention are deemed necessary to rectify the perceived imperfections of the market system in achieving the collective public interest. The State intervenes in order to promote behaviour that, in the absence of regulatory intervention, is believed not to occur.⁴ State regulation is therefore generally identified with the collectivist system.

Divergent views exist as to the reasons why regulation materialised, which actors contributed to its formation, and the patterns of interaction between such actors. Two broad categories of theories of regulation can be identified: the 'public interest' or 'helping hand' theories of regulation and the 'private interest' theories of regulation.⁵

The public interest theories explain regulation as a result of the public's demand for the rectification of the possible failure of some of the assumptions of the market system.⁶ These theories attribute to those who are responsible for the creation and application of

⁴ Ogus (n3) 2.

⁵ M Hantke-Domas, 'The Public Interest Theory of Regulation: Non-Existence or Misinterpretation?' (2003) 15(2) *European Journal of Law and Economics* 165-194 and F McChesney, *Money for Nothing: Politicians, Rent Extraction, and Political Extortion*, (Harvard 1997), chapter 'The Economic Theory of Regulation' 7-19.

⁶ R Posner, 'Theories of Economic Regulation' (1974) 5(2) *The Bell Journal of Economics and Management Science* 335.

regulation, an aspiration to engage in communal goals with the purpose of furthering the general welfare of the community.⁷ An implied conclusion of the public interest theories is that regulation is mainly intended to defend the interests of the general public and thereby attain the common good, that is the socio-economic well-being of society as a whole.⁸ Public interest theorists perceive economic markets as extremely fragile and prone to operate very inefficiently (or inequitably) if left alone.⁹ These theorists account for regulation as a means to achieve the best allocation of scarce resources for individual and collective benefit.¹⁰ Regulation takes the form of an indispensable application of communal power through government, with the purpose of overcoming possible failures of the assumptions of the market system.

Market failures can take various forms. Monopoly is considered as a fundamental market failure since monopolist practices impair competition, which is necessary for market efficiency and the proper allocation of scarce resources.¹¹ Moreover, the serious failure of the unregulated market to generate optimal information in relation to a particular area of decision making leads to uninformed and inefficient consumer choices.¹² In the field of financial regulation the mitigation of information asymmetries is one of the main investor protection objectives. Regulation is instrumental for the correction of market failures and a means to maximise general welfare and society's common economic interests. However, the common good is not defined exclusively in terms of efficient resource use and allocation. The public interest theories of regulation take a broader approach and propose that regulatory intervention by the State is directed towards the socially efficient use of scarce resources. Regulation is therefore necessary for the protection of the vulnerable members of society who, in the absence of regulation, would be subject to social injustice.¹³

⁷ B Morgan and K Yeung, *An introduction to law and regulation* (Cambridge 2007) 17.

⁸ C Uche, 'The theory of regulation: A review article' (2000) 9(1) *Journal of Financial Regulation and Compliance* 68.

⁹ Posner (*n6*) 336.

¹⁰ J Hertog, 'General Theories of Regulation' (1999) 225 <<http://goo.gl/Tx7kMF>> accessed 15.08.11.

¹¹ C Foster, *Privatization, Public Ownership, and the Regulation of Natural Monopoly* (Blackwell 1992) and M Levine and J Florence, 'Regulatory Capture, Public Interest and Public Agenda: Toward Synthesis' (1990) 6 *Journal of Law, Economics and Organisation* (Special Issue) 167-198.

¹² Ogus (*n3*) 38.

¹³ A Ogus, 'W(h)ither the economic theory of regulation? What economic theory of regulation?' in J Jordana and D Levi-Faur (eds), *The Politics of Regulation* (Edward Elgar 2004) 35.

The public interest theories of regulation have been formulated by academics with the aim of proposing what governments and regulatory agencies should do and as a means of explaining what they actually do. They have become the cornerstone of the regulatory philosophy's attempt to justify regulation as applied in modern democratic states. Certain features of these theories have been the subject of much criticism.

One major criticism is that the theories are based on the assumption that government regulation is effective and that it can be implemented without cost. However, regulation could, at times, prove to be unsuccessful in reaching its objective because the regulatory agencies responsible for supervising compliance with regulation are requested to fulfil impossible and sometimes conflicting functions. In attempting to succeed, they distort the efficient functioning of financial markets.¹⁴ Furthermore, effective regulation is very costly and is an area where an increase in output leads to a very sharp increase in the cost of production.¹⁵

Notwithstanding the criticism, it is reasonable to argue that the rationale behind regulation as proposed by the public interest theories of regulation could, even today, contribute a valid academic basis for the comprehension of certain objectives which the regulation of financial services aims to accomplish in practice. Moreover, one may contend that the public interest theories of regulation provoked an examination of whether it was viable to explain the ultimate rationale behind regulatory policy decisions and have unexpectedly led to the formation of certain private interest theories of regulation.

The private interest theories hold that regulation is a reaction to the demands of interest groups striving to increase the revenues of their members.¹⁶ Private interest theorists are generally unconvinced of the so-called public interestedness of policy-makers and regulators.¹⁷ They contend that regulation could frequently be an instrument which benefits particular interest-groups, and not always those members of society it was allegedly expected to benefit. They argue that regulation which is designed to achieve

¹⁴ Posner (n6) 339.

¹⁵ I Ehrlich and R Posner, 'An Economic Analysis of Legal Rule-making' (1974) 3 Journal of Legal Studies 257-286.

¹⁶ Posner (n6) 335.

¹⁷ R Baldwin, M Cave and M Lodge, *'Understanding Regulation: Theory, Strategy, and Practice'* (Oxford 2012) 41-49.

the common good, in fact serves to protect the interests of the industry.¹⁸ These theories are based on the assumption that as a consequence of the high-stakes and the interests in the outcome of policy or regulatory decisions, interest groups affected by regulation will focus their resources and energies to promote the policy outcomes they prefer. As a result of the influence of interest groups the positive aims of regulation are weakened and regulatory efficiency is compromised, with the advantages of regulatory reform ending up being unequally distributed and benefiting those engaged in lobbying the legislators at the cost of society at large.¹⁹

The private interest theories hold that the financial industry controls the government institutions of our society including the regulatory agencies that are responsible for supervising the economy.²⁰ Through such control, the industry can influence the regulatory and supervisory process in a manner that is exclusively to its own benefit.

The capture theory argues that regulation is initially made to serve the general public but that by time, given the effort made, interest groups may capture the influence of policy-makers and regulators and gain the decisions which will serve their interests.²¹ A regulatory agency normally experiences a life cycle in reaction to the political environment.²² Initially such an agency draws the attention of the general public and as a consequence acts with dynamism. Eventually, when the focus is shifted to other subjects, public support is reduced and the regulatory agency becomes open to control by those licensed and supervised by the same agency. Therefore, regulatory capture as explained by political scientists occurs at the stage when the regulatory agency is already an established entity and regulation is being implemented, supervised and enforced.

Three main levels of regulatory capture may be identified. In the beginning, as a result of the pressure made by the regulated, the regulatory agency allows the regulated to breach applicable regulatory requirements. At a second stage, the regulatory agency assists the regulated to avert the regulatory enforcement after the breach of the law is

¹⁸ Baldwin et al (*n17*) 21.

¹⁹ A Estache and D Martimort, 'Politics, Transaction Costs, and Design of Regulatory Institutions' (World Bank 1999) 10<<http://goo.gl/Mt6kJ3>>accessed 15.03.14.

²⁰ Posner (*n6*) 341.

²¹ Hertog (*n10*) 235.

²² Ogus (*n13*) 57.

committed. Finally, the capture becomes so deep that the regulatory agency may even support and guide the regulated to overcome the regulatory regime before a breach is committed. In this context, one may argue that the more a jurisdiction becomes dependent on the success and development of its financial system for its overall economic growth, the more the policy-makers and regulatory agencies of that jurisdiction become prone to regulatory capture by the financial industry.

The capture theory of financial regulation is not sufficiently distinguished from the public interest theory of regulation, given that both these theories base themselves on the assumption that the public interest is the basis for the initiation of regulation.²³ It is unclear why and how the regulated are successful in subjecting the regulatory agency to their interests but fail to prevent the establishment of such an entity by policy-makers. A more remarkable and refined adaptation of the private interest theory of regulation originates from economic theorists, and in particular from the Chicago School of Law and Economics. This adaptation of the private interest theory is generally referred to as the ‘economic theory’ of regulation and is based on the economic assumption that members of society press forward their self-interest and do so in a rational manner. Regulation is thus explained as the outcome of the forces of demand and supply, while the creation and the type of regulation may be expected as a reaction by politicians to the requests of interest groups which could profit from the measure.²⁴

The democratic political system where politicians are subject to re-election and which depends on various variables, including the pursuing of very costly election campaigns, provides the industry with an opportunity to exercise political influence. Politicians who aim to be re-elected may be inclined to honour the demands from the industry for certain types of regulation in exchange for political support which can come in various forms including campaign contributions.²⁵ The central proposition of the economic theory of regulation is that, in the main, regulation operates so as to benefit interest groups not society, and the political system will function in such a manner to ensure that

²³ Hertog (*n10*) 235.

²⁴ G Stigler, ‘The Theory of Economic Regulation’, (1971) 2(1) *The Bell Journal of Economics and Management Science* 3-21.

²⁵ R Kenagy, T Anderson, and M Fox, ‘Regulation and the impact of political lobbying on the investment banking industry’ (2013) 28(5) *Journal of International Banking Law and Regulation* 171-180; and A Wilmarth, ‘Turning a Blind Eye: Why Washington Keeps Giving into Wall Street’ (2013) 81(4) *University of Cincinnati Law Review* 1283-1446.

this will happen.²⁶ Financial regulation may therefore become a means to curtail competition through the introduction of excessive regulatory burdens which may only be complied with by big players within the market.²⁷ The economic theory of regulation has however been criticised on various counts including the fact that this theory is based on the assumptions that interest groups control the result of elections and that policy-makers stick to the requests of such groups.²⁸ These assumptions are challenged on the basis that they simplify the rather complex world of politics and in particular do not fully account for the outcome of the motivation, behaviour and interaction between other political actors such as individual voters, government workers and agencies.

The theories of regulation considered above, attempt to explain what can be referred to as the underlying philosophical rationale for regulation, including the regulation of financial services. Both the public and private interest theories have been heavily criticised and cannot individually be considered as being a conclusive explanation for the regulatory policy response that followed the financial crisis. The public interest theories of regulation, which explain regulation as a means to achieve the general wellbeing of society, may be considered as excessively naive. On the other hand, the private interest theories, which relate the regulatory process totally to individual interests, is exceptionally cynical. Positive elements exist in the contribution of industry lobbyists to the regulatory process. Their input may be beneficial to this process as legislators do not always have complete knowledge and appropriate expertise in the sector which is the subject of a proposal and may therefore not fully understand the implications of the same.

Industry lobby groups share their expertise in the field with legislators, which should, *ceteris paribus*, allow for a more informed decision to be made. It is considered best practice in Western democracies for legislators to formally consult the industry about draft regulatory measures, in order to give those who fall within the scope of the

²⁶ D Gowland, *The Regulation of Financial Markets in the 1990's* (Edward Elgar 1991) chapter 'Economic theory of regulation' 21-35 and G Majone, 'Theories of Regulation' in G Majone (ed) *Regulating Europe* (Routledge 1996) 28-46.

²⁷ J Hendrickson, 'Regulation and Instability in US Commercial Banking' (Palgrave Macmillan 2011) chapter *Theories of Bank Regulation* 10-18.

²⁸ S Peltzman, 'Towards a More General Theory of Regulation' (1976) 19 *Journal of Law and Economics* 211-240.

planned legislation the opportunity to express their views on the proposal. On the other hand, it has been objected that the financial industry lobbyists have extensive privileged access to policy-makers and undue influence on the legislative process in Western democracies.²⁹ A case in point is the tremendous pressure exerted by the financial industry lobby groups on legislators in Brussels with regard to various aspects of the regulatory reform which has been proposed to address the causes of failures of the financial crisis.³⁰ As evidenced by the recent ‘cash for laws’ scandal, at times, the industry lobby may resort to unethical and immoral means to attain its goals.³¹

In practice, basing oneself on the policy response post the financial crisis, it is reasonable to conclude that financial regulation is the result of a combination of factors propounded by the theories of regulation. A regulatory process in the financial field, such as that undertaken in the aftermath of the financial crisis, is generally aimed at achieving a policy initiative which addresses threats to the well-being of the financial system, thus benefiting the interests of society as a whole. However, as the pressure exerted on Brussels by the financial industry goes to prove, this process is more often than not influenced and possibly, at times, redirected by the financial industry lobby groups. By various means such lobbyists aim to satisfy the benefits of the interest groups they represent.

In the final analysis, the outcome of a process which gives rise to financial regulation is the result of a trade-off between implementing a policy designed to attain the common good through substantive law which is strictly aimed at meeting the high-level objectives of financial regulation, and making exceptions to address the points of interest raised by the industry. The latter are attended to, given the expertise of the industry in the field of the proposed regulatory measure, the susceptibility to capture of

²⁹ SpinWatch, ‘Doing God’s Work: How Goldman Sachs Rigs the Game’ March 2011 <www.spinwatch.org>accessed 01.08.11.

³⁰ J Machintosh, ‘Hedge funds move to limit rules burden’ *Financial Times* (London 18.01.09)<www.ft.com>; B Wall and J Machintosh, ‘France to call or Hedge Fund Crackdown’ *Financial Times* (London 12.02.09)<www.ft.com>; J Plender, ‘Re-regulation will fail to curb Bankers’ worst excesses’ *Financial Times* (London 27.05.09)<www.ft.com>; N Tait ‘MEPs pledge to alter hedge fund proposal’ *Financial Times* (London 02.09.09)<www.ft.com>; M Rasmussen, ‘Lobbying the European Parliament: A necessary evil’ (CEPS Brief 242, May 2011)<www.ceps.be>; A Admati, ‘The battle has only just began to regulate the banks’ *Financial Times* (London 03.06.11)<www.ft.com>accessed 27.08.11.

³¹ A Rowell, ‘The Power of Financial Lobbyists Must be Curtailed’ SpinWatch 20.03.11 <www.spinwatch.org>accessed 27.08.11.

public institutions by private interests, and the individual utility-maximisation behaviour of policy-makers.

2.3 Objectives of Financial Regulation

The debate on what should be the high-level objectives of financial regulation has ranged far and wide. It is generally accepted that financial regulation is an instrument of economic policy. As such, the objectives of financial regulation are a function of and are determined by economic policy objectives.³² Economic policy is generally aimed at achieving economic stability and growth. Financial regulation has been found to have a significant influence on the output and productivity growth within an economy.³³ On the other hand, financial market failures, especially those of a systemic nature, could have grave consequences on a country's economic stability and its potential for growth. Financial market failures also have an impact on the confidence which the investing public has in a financial system.³⁴ Public confidence in a financial system is fundamental for the system to be able to function properly and continue to exist.³⁵ Therefore, from an economic policy perspective, the main aim of financial regulation should be that of safeguarding economic integrity and building public confidence in the financial system. Apart from the economic policy aspect, it has been held that financial regulation also has a role to play in achieving consumer policy objectives and in curbing financial crime. It is widely acknowledged that financial regulation should also endeavour to protect the vulnerable users of the financial system from possible market misconduct or the fraudulent conduct of business by financial institutions.³⁶

Policy-makers have established three high-level objectives of financial regulation. The first objective is that of safeguarding the stability of the financial system, primarily by ensuring that financial institutions have adequate capital and that the financial system is properly monitored. The second objective is that of providing an optimum level of investor protection from exploitation and the hazards caused by market failures, by

³² Gowland (*n26*) 39.

³³ A DeSerres and others, 'Regulation of Financial Systems and Economic Growth' (OECD 2007) 32.

³⁴ Gowland (*n26*) 49.

³⁵ E Wymeersch, 'The Structure of Financial Supervision in Europe' (2008) 8(2) European Business Law Review 237-306.

³⁶ Gowland (*n26*) 49.

requiring that financial institutions act in the best interest of their clients. The final objective of financial regulation is that of preserving the integrity of financial markets from market malpractice, such as market abuse and money laundering.³⁷ These are the three core objectives of financial regulation upon which common regulatory and supervisory structures and procedures may be set up on an international dimension.³⁸

From a European perspective, financial regulation strives to create an internal market for financial services. It is argued that the removal of barriers to cross-border financial services enhances economic growth and employment creation, as, *inter alia*, it widens business opportunities for individual financial institutions; it offers financial institutions a better possibility to diversify their business risks; and it increases competition within the EU's financial services industry. However, the opening of national borders within the EU to cross-border business makes regulatory failure in one Member State more prone to generating negative repercussions in other Member States. Regulatory failure in one Member State may threaten investor confidence, systemic stability and market integrity in the Member States which are on the receiving end. This damages mutual recognition and triggers a process of mutual distrust. Indeed, the failures experienced during the financial crisis resulted in different segments of the European financial system to recede along national lines.³⁹ Within this context, the achievement of the three high-level objectives of financial regulation within an environment of harmonised regulation and regulatory and supervisory convergence becomes a key tool to generate mutual trust between Member States and the proper operation of the internal market.

2.3.1 Safeguarding Systemic Stability

A stable financial system supplies a favourable business environment for the efficient allocation of resources and by so doing, supports economic growth. An economy cannot function without financial intermediation, as companies would not be able to obtain the necessary liquidity to conduct their business. Therefore, the financial system serves the

³⁷ IOSCO, 'Objectives and Principles of Securities Regulation' (2010) <<http://goo.gl/xMZ7kf>> accessed 05.02.14.

³⁸ R. Weber, 'Multilayered Governance in International Financial Regulation and Supervision' (2010) 13(3) *Journal of International Economic Law* 683.

³⁹ R. Kelemen, 'Eurolegalism: The Transformation of Law and Regulation in the European Union' (Harvard 2011) 103; and R. Lastra, 'The Role of IMF as Global Financial Authority' (2011) *European Yearbook of International Economic Law* 2.

interests of society by transferring extra savings to companies that require capital to invest. However, when left to themselves financial systems are prone to short periods of volatility and contagion.⁴⁰ Financial systems suffer from what is generally referred to as ‘systemic risk’. The history of the development of financial systems is characterised by various instances of systemic instability, triggered by an unexpected real or likely failure of a systemically relevant financial institution, which eventually results in a fully blown financial crisis. The paths of contagion within the financial system are multifaceted, with the inter-bank/institution market, payment and settlement systems, financial markets, the information channel and the psychological channel being the most noticeable.⁴¹

Systemic risk may be considered from various angles. From a wide perspective it refers to the breakdown of a national or regional or global financial system.⁴² From a narrower point of view, systemic risk may arise due to broad lending mistakes which have an impact on the stability of many financial institutions.⁴³ The financial crisis has altered the understanding of systemic risk. While in the past systemic risk was associated with difficulties in the banking system or some type of financial failure that induces instability in the system, an analysis of the causes of the crisis suggests that systemic instability may also emerge from securities and derivative markets and the interconnectedness within the system.⁴⁴ The legal definition of systemic risk is:

a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree.⁴⁵

The failure of a financial institution may not, *per se*, necessarily be the cause of a financial disaster. In reality, it is the possible dramatic and sudden structural changes in

⁴⁰ H Davies and D Green, ‘Global Financial Regulation: Essential Guide’ (Polity 2008) 15.

⁴¹ R Lastra, ‘Systemic Risk, SIFIs and Financial Stability’ (2011) 6(2) Capital Markets Law Journal 197-213; and P Yeoh, ‘The challenges and implications of systemic risks for financial regulation’ (2010) 31(12) Company Lawyer 389-397.

⁴² H Scott, ‘Reducing Systemic Risk through the reform of capital regulation’ (2010) 13(3) Journal of International Economic Law 763.

⁴³ Scott (*n*42).

⁴⁴ Lastra (*n*41) 199.

⁴⁵ Regulation EU No 1092/2010, article 2.

the equilibrium of the whole financial system that could result from such failure that can generate systemic instability. Therefore, systemic risk may be defined as the possibility that the failure of a financial institution may lead to correlated reactions, which ultimately contribute altogether to the breakdown of the entire financial system.

The vulnerability of the financial system as a result of systemic risk is a matter of concern to policy-makers and to those responsible for safeguarding the integrity of the economy. The financial crisis disrupted economic policy to the detriment of society at large. Austerity measures which had to be implemented in order to dedicate funds to the rescue of financial institutions had an impact on the available resources for social policy programmes such as those dedicated to health and education. In certain instances this has led to social unrest. Therefore, financial regulation aimed at achieving systemic stability by minimising systemic risk is necessary to try and prevent the consequences of a financial crisis on the economy and on society itself. The cost of such consequences may be much higher than those which have to be incurred in order to avert it.⁴⁶

Regulatory measures to mitigate systemic risk

Various regulatory initiatives have been adopted at international, regional, and national level to safeguard systemic stability. As a consequence of the negative impact of the financial crisis on financial and economic stability, the focus of the majority of post-crisis regulatory initiatives aim at dealing with systemic risk. This part of the chapter considers a selection of such regulatory initiatives, which have been categorised as follows: **[i]** the application of prudential requirements; **[ii]** the application of macro-prudential supervision; and **[iii]** measures to address too-big-to-fail.

Prudential requirements

At the micro-level, requiring financial institutions to comply with prudential capital requirements has been the traditional means to ensure that individual members of the financial system are resilient and are therefore in a position to confront financial shocks and imbalances. At international level, the BCBS has, since its inception in 1974,

⁴⁶ D Llewellyn, 'The Economic Rationale for Financial Regulation' (FSA 1999) 13<
<http://goo.gl/XM6GwU>>accessed 15.03.14.

promoted prudential capital standards applicable to banks, known as the Basel Capital Accord, which was adopted in 1988.⁴⁷ Basel 1 had the purpose of ensuring that a bank's capital would be sufficient to provide for credit risk. The first major reform of the Basel Capital Accord took place in 2004 with the adoption of Basel II, which provided for calculation of market and operational risks. It established the three pillar model of prudential regulation, being: Pillar I setting the minimum prudential capital requirements; Pillar II establishing an internal capital adequacy assessment process applicable to banks and a supervisory review process for financial supervisors; and Pillar III stipulating requirements on disclosure of capital and risks.⁴⁸ In 2010 another major revision of the Basel Capital Accord was adopted to address the risks identified in the wake of the financial crisis.⁴⁹ On a European level, various proposals for reform were made in the DeLarosiére Report,⁵⁰ including proposals for the revision of the CRD⁵¹ that sets the prudential capital requirements applicable to banks operating in the EU.

In terms of CRD IV⁵², banks will be required to hold better and more capital and to manage cash and liquidity in a more effective manner. Banks will also be required to hold conservation buffers and countercyclical buffers to cover the impact of a possible sudden financial crash and to sustain economic downturns. Banks will be required to have more robust governance procedures and internal controls in place. They will also be required to significantly reduce their reliance on external credit ratings by adopting a wider application of internal risk measurement and management processes and functions. Poor governance structures, lack of internal controls, weak risk management functions and extensive reliance on credit ratings form part of the list of causes which brought about the financial crisis.

The stability of a financial system depends on the financial soundness and robust governance of the individual financial institutions. While prudential capital requirements seek to ensure the financial stability of a financial institution, the

⁴⁷ Basel 1988 Capital Accord<<http://www.bis.org/bcbs/index.htm>>accessed 26.01.14

⁴⁸ Basel 2004 Capital Accord<<http://www.bis.org/bcbs/index.htm>>accessed 26.01.14

⁴⁹ BCBS<<http://www.bis.org/bcbs/index.htm>>accessed 14.08.11.

⁵⁰ 'High-Level Group on Financial Supervision in the EU – Report' (Brussels, 25.02.09) 15–19<<http://goo.gl/CroZY>>accessed 15.03.14.

⁵¹ Directive 2006/48/EC and Directive 2006/49/EC.

⁵² Regulation (EU) No575/2013 and Directive 2013/36/EU.

sustainable growth of such an institution largely depends on the way it is governed; the way it conducts its business; its awareness of the risks to which it is exposed and the healthy management of those risks.⁵³ A healthy financial institution is one which has in place sound administrative procedures and internal control mechanisms, including a well-documented organisational structure that clearly assigns responsibilities and ensures a good flow of information between all parties involved, in particular senior management and the board of directors. It may be argued that an effective governance structure for a financial institution would in practice ensure that senior management understand, control and manage the activities of the institution, while the board of directors takes an active monitoring role by challenging policy decisions recommended by senior management and checking on their overall conduct of the business. Having proper control mechanisms in place is fundamental to maintaining the integrity and stability of the financial institution and to keep in check any possible excessive risk taking or illicit activity.

An effective risk management function is also of cardinal importance since risk management is a fundamental tool to ensure that the financial institution does not engage in excessive risk taking which could impact its long term sustainability. So fundamental is the application of risk management tools for the proper performance of financial activities, that competence in risk management is said to be one of the crucial determinants of competitive success for a financial institution.⁵⁴ The application of weak risk management procedures is likely to result in business decisions which could impact on the financial soundness of a financial institution.

The prudential requirements set in the proposed CRD IV aim at creating mitigating factors that address systemic risk in the banking sector, thereby implementing the G20 policy commitment to require banks to have more robust capital, governance and organisational structure.⁵⁵ The proposal, however, also applies to investment firms. Although banks and investment firms may be subject to similar risks, such as market risk and operational risk, certain requirements set in the proposal focus entirely at addressing issues emerging from the banking sector and do not seem to make an

⁵³ Commission, 'Green Paper: Corporate governance in financial institutions and remuneration policies' COM(2010)284, 02.06.10<<http://goo.gl/UWbPG3>>accessed 15.03.14.

⁵⁴ C Szylar, *Risk Management under UCITS III/IV* (Wiley 2010) xi.

⁵⁵ M Barnier, 'Speech on CRD IV', Speech/11/533, Brussels<www.europa.eu>accessed 22.04.12.

exception to the business model of investment firms, which at times differs significantly from that of banks. This is particularly true with regard to small and medium sized investment firms that are generally involved in very basic services such as the provision of investment advice and the execution of orders on behalf of clients, who invest primarily in non-complex financial instruments and do not actively trade on the market.

The Commission's impact assessment on this proposal goes to great lengths in addressing concerns relating to the banking sector but makes minimal reference to the possible impact that the proposal could have on investment firms.⁵⁶ This suggests that in drafting this proposal the Commission's focus was that of addressing weaknesses in the banking sector. It also suggests that not enough attention was therefore paid to the particularities of investment firms.⁵⁷ In the process, however, certain requirements that are relevant to address bank related risks that could threaten the stability of a financial system have been applied to investment firms, even though these are not relevant to these types of firms. By way of example, while the proposed capital buffers were devised to ensure that banks can withstand losses during a period of systemic instability, these requirements are also being applied to investment firms, even though these type of firm are not considered as systemically relevant.

The proposal has been incorporated in a draft Regulation, which by nature is a legislative instrument that is directly enforceable and does not require transposition into national law, thereby making it impossible for Member States to adapt the requirements of CRD IV to the circumstances of their industry.⁵⁸ A one size fits all approach to regulation, coupled with a maximum harmonisation legal measure, raises potential issues of proportionality, which is a fundamental principle of EU Law. The Commission attempts to justify this approach on the basis that differences in the implementation of EU law and in the regulation of banks and investment firms could cause regulatory

⁵⁶ Commission, 'Impact Assessment: Proposal for a Regulation on prudential requirements for credit institutions and investment firms', Brussels, 20.7.2011, SEC(2011)950<<http://goo.gl/UppQPL>>accessed 15.03.14.

⁵⁷ C Buttigieg, 'Implementing CRD for investment firms: Challenges for Malta' (2012) 20(4) Journal of Financial Regulation and Compliance 417-432.

⁵⁸ Buttigieg (n57).

arbitrage. Moreover, it is also argued that local failures in Member States could have European wide repercussions.⁵⁹

It is reasonable to contend that CRD IV is important to address the weaknesses of the banking sector that could form a threat to systemic stability. Albeit, capturing investment firms, particularly small and medium sized firms, within the scope of an EU Regulation the main purpose of which is to address systemic risk, does not respect the differences in the business model of banks and investment firms, is not proportionate and may result in over-regulation.⁶⁰ This may be indicative of an over-zealous approach to regulation that was triggered post the financial crisis, whereby a special concern with creating the right regulatory environment to prevent the next crisis, may lead to over-regulation and generate laws that do not fully respect all the high-level principles of EU Law.

Macro-prudential supervision

One of the fundamental lessons drawn from the financial crisis is that micro-prudential supervision on its own is not enough to safeguard the stability of the financial system. Having a dedicated systemic regulator responsible for macro-prudential supervision is as fundamental as micro-prudential supervision for the well-being of the financial system.⁶¹ This was one of the key conclusions of the DeLarosiére Report.⁶² The financial crisis has demonstrated that even where the individual components of the financial system seem sound, this does not necessarily mean that the system as a whole is sound. Therefore, macro-prudential supervision supplements traditional micro-prudential supervision of individual financial institutions with specific focus on the possible threats to the financial system as a whole. Macro-prudential oversight demands the identification of emerging financial risks and structural weaknesses in the financial system. Various monitoring tools and interventionist powers have been granted to regional and national financial supervisors in order to ensure that they are in a position to monitor the conventional and shadow banking system so as to identify the possible

⁵⁹ Commission, ‘CRDIV/CRR Frequently Asked Questions’ 16.07.13<<http://goo.gl/KhFTKG>>accessed 05.03.14.

⁶⁰ Buttigieg (n57).

⁶¹ K French, ‘*The Squam Lake Report – Fixing the financial system*’ (Princeton 2010) 33-43.

⁶² (n50) 39.

build up of systemic risk and to take the necessary measures to contain it.

At European level a new regulatory agency was established. The European Systemic Risk Board ('ESRB') has the responsibility for macro-prudential supervision and is intended to contribute to the prevention and mitigation of systemic risk.⁶³ In pursuing its macro-prudential mandate, the ESRB performs a number of key activities, namely risk monitoring, risk assessment and, if deemed appropriate, the adoption of policy response.⁶⁴ As a policy response the ESRB may adopt warnings and recommendations.⁶⁵ Although the ESRB recommendations are soft law mechanisms and as such are not legally binding, the addressee is subject to a 'comply or explain' mechanism, which means that the addressee has to report to the ESRB the manner of compliance or otherwise explain why it has chosen not to comply.⁶⁶ Decisions at the ESRB are made by the general board which is made up of thirty seven voting and twenty eight non-voting members and is chaired by the President of the ECB. The membership is made up of representatives of the European authorities, national central banks and financial supervisors. Decisions are made by a majority vote.

Comparable macro-prudential bodies were also established in some Member States at national level, as well as outside the EU, with the most prominent example being the Financial Stability Oversight Council ('FSOC') in the US, set up under the Dodd Frank Act⁶⁷. The FSOC is a collaborative institution chaired by the Secretary of the Treasury that brings together the federal financial regulators, an insurance expert appointed by the President, and state regulators.⁶⁸ It has the statutory duty to facilitate the sharing of data and information among the member agencies, designate non-bank financial companies for consolidated supervision and non-banking entities as systemically relevant and requiring them to meet prescribed risk management standards.⁶⁹ While the FSOC monitors the financial system and has the power to make regulatory decisions on the entities that qualify as systemically relevant financial institutions, in terms of the

⁶³ Regulation (EU) No1092/2010, recitals 6, 10 and article 3.

⁶⁴ F Dierick, P Lennartsdotter and P DeFavero, 'The ESRB at work – its role, organization and functioning' ESRB Macro-prudential Commentaries February 2012<<http://goo.gl/dyPnYw>>accessed 07.02.14.

⁶⁵ Dierick *et al* (n64) 4.

⁶⁶ G Barber, 'The European Systemic Risk Board' (2011) 32(8) Company Lawyer 225-226.

⁶⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L.111-203 (2010).

⁶⁸ Dodd-Frank Act, sections 111-123.

⁶⁹ Dodd-Frank Act, section 112.

Dodd Frank Act it is the Federal Reserve System that has the responsibility to supervise such institutions, including non-bank financial institutions.⁷⁰

As in the case of the ESRB for the EU, prior to the FSOC there was no single government entity responsible for monitoring the entire financial system in the US. Rather, different government regulators were responsible for segmented fractions of the financial system, thereby leaving room for regulatory gaps. From a governance perspective the FSOC has nine voting members (mainly the federal regulators⁷¹) and five non-voting members⁷² and decisions are made by a majority vote.⁷³ This governance model differs from that of the ESRB as the FSOC's balance of power is heavily tilted towards federal regulators while that of the ESRB favours the financial supervisors at national level. Moreover, given the significantly lower number of voting members, in first instance the FSOC's governance model may be perceived as potentially being more effective for the purpose of decision making than that of the ESRB. Albeit, the FSOC's role as coordinator for macro-prudential purposes is still a challenging task as voting members represent independent federal agencies with overlapping jurisdictions and different responsibilities who may not always be willing to cooperate.⁷⁴

In the EU, the governing body of the ESRB is composed of a large number of representatives since participation by the national supervisors seeks to ensure that the carrying out of macro-prudential supervision is interwoven with micro prudential supervision, which, with the exception of banks in the Eurozone, is still predominantly undertaken at national level.⁷⁵ However, this governance arrangement is now being

⁷⁰ R Lastra, 'Legal and Regulatory Responses to the Financial Crisis', Queen Mary Research Paper100/2012 6<<http://goo.gl/WAuNYP>>accessed 31.12.13; B Geva, 'Systemic risk and financial stability: the evolving role of the central bank', (2013) 28(10) Journal of International Banking Law and Regulation 403-417.

⁷¹ Comptroller of the Currency; Federal Deposit Insurance Corporation; Consumer Financial Protection Bureau; Federal Housing Finance Agency; Federal Reserve System; Independent Member with Insurance Expertise; National Credit Union Administration Board; Commodity Futures Trading Commission; and Securities and Exchange Commission.

⁷² Federal Insurance Office; Office of Financial Research; State Banking Supervisor; State Insurance Commissioner; and State Securities Commissioner.

⁷³ Dodd-Frank Act, section 111.

⁷⁴ US Government Accountability Office, 'Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions' GAO-12-886 13.09.12<<http://goo.gl/KBTbVt>>accessed 31.01.14.

⁷⁵ Dierick *et al* (n64) 4.

criticised as too unwieldy, difficult to stir and getting into action and therefore requiring some simplification and streamlining.⁷⁶ In this context, it is relevant to mention that given the apparent mismatch between integrated and interconnected European financial markets and predominately national supervision at the level of the Member States, the EU also established three regulatory authorities: European Securities and Markets Authority ('ESMA'), European Banking Authority ('EBA') and European Insurance and Occupational Pensions Authority ('EIOPA'). These are responsible for micro-prudential supervision and also have the task of cooperating and assisting the ESRB to achieve its macro-prudential statutory objectives. This institutional framework has been complemented by various new regulatory initiatives adopted by the European Institutions which provide national financial supervisors with additional supervisory tasks and powers in order that they may achieve the systemic stability objective.

It is interesting to note that all the new regulatory initiatives in the field of securities regulation issued by the EU in the aftermath of the financial crisis refer to the mitigation of systemic risk as one of the primary objectives of regulation. By way of example, the AIFMD⁷⁷, which regulates the activity of portfolio managers of alternative investment funds, refers to the possible build up of systemic risk which may be generated as a consequence of the employment of leverage by these managers.⁷⁸ In order to ensure that financial supervisors are in a position to monitor such activity, the AIFMD requires fund managers to report to their financial supervisor information on their leverage positions, which information must be shared with other financial supervisors and the ESRB.⁷⁹ The Directive also gives financial supervisors the power to set limits to leverage positions of a fund manager where these positions are considered as being potentially risky for the stability of the financial system.⁸⁰

The Directive, which also aims at protecting investors, particularly from losses of financial instruments that are held by the depositary on behalf of the AIF, imposes strict liability on the depositary for any losses of such instruments, even where the assets are

⁷⁶ J DeLarosiére, 'Speech - Public Hearing on Financial Supervision in the EU' (Brussels 24.05.13) <<http://goo.gl/mmdfl9>>accessed 05.02.2014.

⁷⁷ Directive 2011/61/EC.

⁷⁸ Directive 2011/61/EC, recital 49.

⁷⁹ Directive 2011/61/EC, recital 50 and article 25.

⁸⁰ Directive 2011/61/EC, article 25.

held by a sub-custodian.⁸¹ It may be argued that this requirement addresses investor protection issues arising from the losses sustained by a number of funds due to the Madoff fraud⁸². It however raises potential competition issues as a higher degree of liability may result in being too costly for small depositaries to sustain, thereby reducing the feasibility of depositary business for small and medium sized firms. As a consequence, the number of active depositaries could decrease, thereby increasing concentration risk in fewer, but larger depositaries, which in turn increases the probability of systemic risk in case of failure. This suggests that the importance of attaining a fundamental objective of financial regulation could, at times, result in regulatory measures that cause tensions with and possibly weaken the realisation of other regulatory and economic objectives.

Measures to address too-big-to-fail

The financial crisis reignited the debate on the too-big-to-fail doctrine.⁸³ This doctrine is understood to mean

that, if a bank were big enough, it would receive financial assistance to the extent necessary to keep it from failing. More specifically, the too-big-to-fail doctrine implies that all deposits obligations would be met by some form of government guarantee or pledge.⁸⁴

Originally the too-big-to-fail doctrine was mostly associated with the banking sector and the size of individual institutions. The financial crisis has however brought to light a new dimension to this doctrine, in that too-big-to-fail may arise in the non-banking

⁸¹ Directive 2011/61/EC, article 21.

⁸² A Sage, 'French investors to take legal action against banks over Madoff feeder funds' *The Times* (London 14.01.09) <www.timesonline.co.uk>; P Skypala, 'UCITS victory soured by Madoff scandal' *Financial Times* (London 19.01.09) <www.ft.com>; EurActiv, 'Madoff scandal sparks EU row' (Brussels 21.01.09) <www.euractiv.com> accessed 22.04.12.

⁸³ House of Commons, 'Too Important to Fail – Too Important to Ignore', Report of the Treasury Select Committee, Session 2009-10, HC261-1 <<http://goo.gl/NPOkuu>> accessed 08.02.14; and R Nattrass, 'The Too Big to Fail Problem: Fault Lines Open Up' (2010) 25(6) *Journal of International Banking and Financial Law* 353.

⁸⁴ P Molyneux 'Banking Crises and the Macro Economic Context' in R Lastra and H Schiffman (eds) *Bank Failures and Bank Insolvency Law in Economies in Transition* (Wolters Kluwer 1999).

sector and that it is not only a function of size but may also arise from institutions that are too interconnected to fail.⁸⁵

In the lead-up to the financial crisis, financial institutions took large risks while implicitly relying on the purported guarantee that if something went wrong the government would intervene.⁸⁶ During the crisis governments in the US and a number of EU Member States made considerable financial interventions to save financial institutions from failing.⁸⁷ Given the level of interconnectedness in the financial system and size of financial institutions, government intervention was considered necessary so as to avoid a general financial meltdown. At the time, financial regulation did not provide the tools for the orderly resolution of financial institutions, particularly where these were of a significant size, highly interconnected and active in providing cross-border services.⁸⁸ In such an environment, too-big-to-fail is considered as *doubly* damned.⁸⁹ On the one hand, given the complexities, difficulties and weakening of confidence in the financial system that may result from the failure of a financial institution of a significant size, governments could ill afford to let these institutions fail. On the other hand, however, government intervention resulted in a greater degree of moral hazard, as the implicit guarantee that governments would always save a failing bank had been confirmed.

To address the moral hazard which results from too-big-to-fail, at international level the BCBS, the Financial Stability Board ('FSB'), the International Association of Insurance Supervisors ('IAIS') and the International Monetary Fund ('IMF') proposed various policy measures to be adopted at regional and national level in order to improve the capacity of authorities to resolve systemically relevant financial institutions, including in situations where these institutions are undertaking cross-border business, without

⁸⁵ T Huertas and R Lastra, 'The Perimeter Issue: To what extent should Lex Specialis be extended to systemically significant financial institutions?' in R Lastra (ed), *'Cross-border Bank Insolvency'* (Oxford 2011) 273.

⁸⁶ M Waibel, 'Bank Insolvency and Sovereign Insolvency' in R Lastra (ed), *'Cross-border Bank Insolvency'* (Oxford 2011) 364.

⁸⁷ Waibel (n86) 365.

⁸⁸ M Krimminger, 'Ending too big to fail: Practical resolution alternatives for financial conglomerates' in R Lastra (ed), *'Cross-border Bank Insolvency'* (Oxford 2011) 282 and K Alexander, 'Bank resolution and recovery in the EU: enhancing banking union?' (2013) 14(1) ERA Forum 81-93.

⁸⁹ Huertas *et al* (n85) 251-255.

disruption to the financial system of the jurisdictions where they operate and without exposing society to the risk of severe losses.⁹⁰

In the European context, the European Institutions have adopted a framework for crisis management which has the purpose of granting authorities the necessary powers and tools to manage the failure of a bank by either restructuring it or ensuring its orderly winding down.⁹¹ To address the lessons of the financial crisis about the systemic relevance of non-banks, the EU is currently contemplating the establishment of a similar framework for systemically relevant non-bank financial institutions.⁹² In the US, similar action to address the lessons of the crisis was taken through the adoption of a framework entitled the Orderly Liquidation Authority as part of the Dodd-Frank Act, which allows the Federal Deposit Insurance Corporation to resolve a failing non-bank systemically relevant financial institution in the same way it would resolve a bank.⁹³

Moreover, there are a number of recent banking structural reform initiatives in Europe and in the US that go beyond internationally agreed reforms. These initiatives have the purpose of: [i] restricting the financial safety net protection to core financial system functions; [ii] reducing the risk of cross-contamination of commercial and investment banking and of their respective cultures; and [iii] increasing the resolvability of systemically relevant financial institutions.⁹⁴ In Europe the Commission has proposed a regulation that would impose a ban on speculative activity by banks and would potentially require them to separate other risky trading activity from their core banking

⁹⁰ BCBS, 'Report and Recommendations of the Cross-border Bank Resolution Group' March 2010<<http://goo.gl/2hbbp7>>IMF 'Resolution of Cross-border Banks: A Proposed Framework for Enhanced Cooperation' 11.06.10<<http://goo.gl/OJ94LJ>>FSB, 'Effective Resolution of Systematically Important Financial Institutions – Recommendations and Timelines' 19.07.11<<http://goo.gl/BcK3aO>>; FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' October 2011<<http://goo.gl/KyV7Y7>>; FSB, 'Resolution of Systemically Important Financial Institutions: Progress Report' November 2012<<http://goo.gl/wfhU66>>; FSB, 'Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Regimes' 16.07.13<<http://goo.gl/AyaXx5>>; IAIS, 'Globally Systemic Important Insurers: Policy Measures' 18.07.13<<http://goo.gl/gia2rw>>accessed 08.02.14.

⁹¹ R Tomasic, 'The emerging EU framework for bank recovery and resolution' (2011) 2 Corporate Rescue and Insolvency 40; and Commission, 'Commissioner Barnier welcomes trilogue agreement on the framework for bank recovery and resolution', (Memo/13/1140), 12.12.13<<http://goo.gl/ylkzG1>>accessed 08.02.14.

⁹² Commission, 'Consultation: Framework for the recovery and resolution of non-bank financial institutions' 05.10.12<<http://goo.gl/lm5mIW>>accessed 08.02.14.

⁹³ J Bromley and T Phillips, 'International Lessons from Lehman's Failure: A cross-border no man's land' in R Lastra (ed), 'Cross-border Bank Insolvency' (Oxford 2011) 432.

⁹⁴ FSB, 'Monitoring the effects of agreed reforms on emerging market and developing economies' 12.09.13<<http://goo.gl/mRXGIU>>accessed 01.03.14.

functions.⁹⁵ The proposal builds on the recommendations made by the Liikanen High-Level Expert Group and should facilitate bank resolution and recovery which in times of stress should translate in lower costs of bank failure.⁹⁶ In the US action to segregate core banking activity from speculative functions have been made through the adoption of the “Volcker Rule”⁹⁷ which prohibits a banking entity from engaging in proprietary trading or investing in, sponsoring, or having certain other relationships with hedge funds or private equity funds.⁹⁸

Although, there are some differences in the way the EU and the US have dealt with the issues pertaining to systemically relevant financial institutions, the ultimate goal of the foregoing regimes on both sides of the Atlantic is that of strengthening the resilience of the financial system. In the final analysis the mentioned regulatory regimes demonstrate policy-makers’ determination to end the too-big-to-fail moral hazard by establishing the mechanisms to ensure that risky business within systemically relevant financial institutions, is segregated from economically important aspect of their activity, and that such entities may be wound down in ways which would minimise the risks of contagion and the negative impact on the continuity of the financial system.⁹⁹

The effect of the financial crisis on the liquidity and viability of several US and European financial institutions confirms the potential systemic instability which could be generated by conditions which are likely to result in the failure of systemically relevant financial institutions. It proves that, due to the interconnectedness of financial institutions, irresponsible practices within one systemically relevant financial institution are likely to cause severe systemic instability and can lead to a possible general collapse of the system as a whole.¹⁰⁰ Although safeguarding systemic stability has long been a primary objective of financial regulation, the regulatory framework applicable before the financial crisis has been proven inadequate to deal with the failures of systemically

⁹⁵ Commission, ‘Proposal for a Regulation on structural measures improving credit institutions’ 29.01.14 COM(2014)43<<http://goo.gl/aGAUSJ>>accessed 01.03.14.

⁹⁶ ‘High-Level Expert Group on reforming the structure of the EU banking sector - Report’ 02.10.12 <<http://goo.gl/we411X>>accessed 01.03.14.

⁹⁷ Dodd-Frank Act, Section 619.

⁹⁸ C Whitehead, ‘The Volcker Rule and Evolving Financial Markets’ (2011) 1(1) Harvard Business Law Review 39-73.

⁹⁹ Commission, ‘Technical Details of a Possible Framework for Recovery and Resolution’, 06.01.11<<http://goo.gl/bjpd2B>>accessed 15.03.14.

¹⁰⁰ E Avgouleas, ‘Financial Regulation, Behavioural Finance and the Global Credit Crisis: In search of a new regulatory model’ (2008) 10<www.ssrn.com>accessed 05.08.11.

relevant financial institutions. Financial supervisors were clearly not prepared and did not have adequate powers to deal with a crisis of such proportion. The financial crisis, its victims, the negative impact it had on the financial system and the economy worldwide brought the regulation of systemic risk high on the Western world's policy-makers' regulatory and supervisory agenda. In the final analysis, one may conclude that the widespread regulatory measures which have been or are in the process of being adopted to deal with systemic risk, attest to the continuing relevance and importance of this primary objective of financial regulation. Undoubtedly, there is today an even stronger case for more robust macro and micro prudential financial regulation aimed at maintaining systemic stability.

2.3.2 Investor Protection

It is submitted that regulation for the purpose of safeguarding systemic stability is however not enough to ensure a sound financial system. Appropriate regulation to protect the interests of investors is considered a fundamental element for the healthy development of financial markets which form an integral part of the financial system.¹⁰¹ There is both empirical and theoretical literature that advocates that a country's level of investor protection has a significant effect on the value of companies, the development of the financial market and economic growth.¹⁰² It is indeed reasonable to argue that inadequate investor protection restricts the economy's access to capital, in particular to equity capital, as the existence of a financial market depends on the confidence which investors have in such market. In turn, public confidence depends on whether investors perceive that financial institutions are acting honestly, fairly and in the best interest of their clients and the financial market.¹⁰³ It also depends on the extent to which financial institutions are perceived to be financially solvent. Hence, the basic rationale for the investor protection objective of financial regulation is that of ensuring investor confidence in the financial market by protecting the investor from the possible consequences of the information asymmetries that exist between the investor and the

¹⁰¹ G Pimlott 'The Reform of Investor Protection in the UK' (1985) 7 *Journal of Comparative Business and Capital Market* 141-172.

¹⁰² R LaPorta and others, 'Investor Protection and Corporate Governance' (2000) 58(1-2) *Journal of Financial Economics* 3-27.

¹⁰³ L Guiso, 'Trust and Risk Aversion in the aftermath of the Great Recession' (2012) 13(2) *European Business Organisation Law Review* 195-209.

financial services provider.¹⁰⁴

The provision of financial services is a field of business which is characterised by information asymmetries between the financial institution and its clients. This is largely the case given that clients are purchasing from the financial institution a professional service that is based on expert knowledge. There are two principal forms of information asymmetries to which an investor is exposed, being the disparity in the ability of an investor to get access to and evaluate financial information and the fact that information is generated on a small scale.¹⁰⁵ Empirical evidence indicates that investors generally fail to get access to adequate financial information and are usually financially illiterate.¹⁰⁶ The difference in knowledge between the financial institution and the investor could have a grave impact on the investor if the said financial institution becomes insolvent while holding and controlling the said investor's assets.¹⁰⁷

Investors are not always in a position to assess the safety and soundness of the financial institution to which they entrust their assets and therefore it is argued that financial regulation has a role to play in ensuring that investors' assets are properly safeguarded.¹⁰⁸ There are consequences which could result from the failure of financial institutions that differ from the systemic consequences explained earlier on. These include the potential insecure economic situation that could hit investors as a consequence of the failure of a financial institution which is responsible for holding and controlling the said investors' financial assets. Safeguarding systemic stability is therefore not the only reason why financial regulation should aim at reducing the risk of failure of financial institutions through the application of prudential regulation.

Due to its very nature, the provision of financial services is inherently prone to principal-agent conflicts of interest and to the occurrence of fraud.¹⁰⁹ A conflict of interest arises when a person who has a duty to act in another party's interest has to decide how to act in the interest of that party while another interest interferes with his

¹⁰⁴ C Goodhart, *'The Central Bank and the financial system'* (MIT 1995) 434.

¹⁰⁵ S Collins and J Black, *'Cranston's Consumers and the Law'*, (Cambridge 2000) 30-4.

¹⁰⁶ A Georgosouli, *'Investor Protection Regulation: Economically Rational?'* (2006) <www.ssrn.com> accessed 15.08.11.

¹⁰⁷ Goodhart (n104) 434.

¹⁰⁸ C Goodhart and others, *'Financial Regulation: Why, how and where now?'* (Routledge 1998) 5.

¹⁰⁹ Goodhart *et al* (n108) 5.

ability to decide according to his duty.¹¹⁰ Nearly all financial market transactions undertaken by unsophisticated investors are made through, and with the assistance of financial institutions that act as intermediaries between the investor and the financial market. In their role as agents of investors, financial institutions have, in theory, a duty to act in the best interest of such investors. However, in practice, when acting as agents of an investor, financial institutions have to balance the interests of various parties, including their own interests, the interests of their employers, those of issuers and the investors. Given the presumed asymmetric information between the investor and the financial institution, the likelihood of opportunistic conduct by the financial institution would seem to be considerably high, not least because the performance of an investment materialises after the point of sale and not before.¹¹¹

Various instances of financial product mis-selling came to light in the aftermath of the financial crisis. Consumer complaints were filed with financial supervisors in view of the sharp declines in financial product values or the application of redemption gates due to liquidity concerns.¹¹² The practice of selling complex financial products to unsophisticated retail investors had been an industry practice over the years.¹¹³ Financial institutions have been found responsible for either having sold financial products which turned out to be inadequate given the investors' profile or to have misled or misinformed clients regarding the nature of the product being sold by failing to communicate effectively the likely outcomes and risks involved.¹¹⁴ Moreover, empirical research has demonstrated that in many cases the advice on financial products provided to retail investors was more in the financial institution's interest than in the investor's interest.¹¹⁵ These attest to the possible negative consequences of the information asymmetries between the investor and the financial institution and sustain

¹¹⁰ C Kumpan and P Leyens, 'Conflicts of interest of Financial Intermediaries – Towards a Global Common Core in Conflicts of Interest Regulation' (2008) 1 *European Company and Financial Law Review* 72-100.

¹¹¹ Georgosouli (n106).

¹¹² Deloitte, 'Product Intervention: An overview of some recent national initiatives' September 2011 <www.deloitte.com> accessed 17.11.12.

¹¹³ CESR, 'Trends, Risks and Vulnerabilities in Financial Markets, (July 2010) <<http://goo.gl/bvWyNY>> accessed 18.12.12.

¹¹⁴ B Masters, 'Mis-selling cases to get fast track' *Financial Times* (London 02.08.11) <www.ft.com>; and A Jones, 'Lloyds profits wiped out by mis-selling charge' *Financial Times* (London 02.08.11) <www.ft.com> accessed 24.08.11.

¹¹⁵ Commission, 'Consumer Market Study on Advice within the Area of Retail Investment Services' (2011) <<http://goo.gl/Uy73FW>> accessed 31.12.12.

the validity of investor protection as one of the high-level objectives of financial regulation.

Regulatory initiatives to achieve investor protection

Regulation protecting investors attempts to address failures which may occur due to asymmetric information, by requiring financial institutions to abide by detailed conduct of business rules that have the purpose of regulating the activity of such institutions in a way which compels them to act in the best interest of the investor. Investor protection regulation is also based on transparency rules that require financial institutions to provide proper information to clients in order to allow them to make an informed investment decision.

From an institutional perspective the three supranational micro-prudential financial supervisors created by the EU post the crisis, EBA, EIOPA and ESMA, have *inter alia* been granted the task of fostering consumer protection.¹¹⁶ For this purpose, and with the aim of coordinating the performance of this task, a joint committee on consumer protection and financial innovation was set up by the three ESAs.¹¹⁷ The joint committee ensures the necessary degree of cross-sectoral consistency in the field of consumer protection regulation which is important if regulatory arbitrage that could be detrimental to the consumer is to be prevented. In the US, a new agency with wide powers to achieve consumer protection by regulating abusive practices as well as unfair and deceptive ones, the Bureau of Consumer Financial Protection ('CFPB'), was established¹¹⁸ in accordance with the Dodd-Frank Act.¹¹⁹ The purpose of creating the CFPB was that of consolidating into one agency the consumer protection powers that had existed across several different federal agencies. The CFPB, which is an agency housed under the Federal Reserve System, has a wide remit with rulemaking, supervision and enforcement powers over nearly all firms involved in consumer

¹¹⁶ Regulation (EU) No1093/2010, article 8(h) and 9; Regulation (EU) No1094/2010, article 8(h) and 9; Regulation (EU) No1095/2010, article 8(h) and 9.

¹¹⁷ ESMA <<http://goo.gl/KB19Ab>>accessed 08.02.14.

¹¹⁸ CFPB, 'Building the CFPB: Progress Report' 18.07.11 <<http://goo.gl/Q6sqo6/>>accessed 08.02.14; A Levitin, 'The Consumer Financial Protection Bureau: An Introduction' (2013) 32 Review of Banking and Financial Law 321-369; J Braucher, 'Form and Substance in Consumer Financial Protection' (2012) 7 Brooklyn Journal of Corporate, Financial and Commercial Law 107; J Zywicki, 'The Consumer Financial Protection Bureau: Savior or Menace?' (2013) 81(3) George Washington Law Review 856-928.

¹¹⁹ Dodd-Frank Act, section 1011.

financial services, irrespective of their particular legal form.¹²⁰

From a regulatory perspective, the key piece of regulation for investor protection in the EU is the MiFID¹²¹ which, *inter alia*, stipulates detailed organisational, conduct of business and transparency requirements applicable to financial institutions which act as an intermediary between investors and the financial markets with respect to the buying and selling of financial instruments.

However, due to remuneration incentives which seek to induce hard selling of financial products and possible failures in the proper application of internal compliance procedures, financial institutions sometimes fail to act in the best interest of their clients. Investors do not always understand the nature and risks relating to their investments, either because the investors do not have the necessary financial knowledge and experience and/or the financial institution has failed to provide the client with proper explanations on the particular financial product. In certain instances financial product documentation is not written in plain language and consequently it is not easily understood by investors. One may therefore contend that providing an optimum level of investor protection from exploitation by financial institutions through robust conduct of business rules and transparency requirements remains an exceptionally valid objective of financial regulation. In this regard, post the financial crisis, the Commission initiated a review of the MiFID with a view to making structural reforms aimed at achieving a higher degree of investor protection.¹²² The amendments propose the inclusion of banking structured products within the framework of MiFID so as to ensure consistent cross-sectoral investor protection between banking and securities.

In the context of the debate on the quality of investment advice provided to clients, as examined in the light of the product mis-selling scandals, advisors would be required to inform the client on whether the investment advice is based on an independent and fair analysis of the client's knowledge and experience, his investment objectives and his financial situation. Advisors would also be required to report to the client in writing the underlying reasons for the advice provided, including an explanation about how the

¹²⁰ Levitin (*n118*).

¹²¹ Directive 2004/39/EC.

¹²² Commission, 'Consultation: Review of MiFID' Brussels 08.12.10< <http://goo.gl/Z3XmM1>>accessed 15.03.14.

advice meets the client's profile. Moreover, the proposed MiFID II would also restrict the inducements which may be received by investment firms from issuers and product providers.¹²³ It is submitted that these requirements, particularly those that restrict the possibility of taking inducements from product providers, are likely to mitigate some of the factors that could contribute to abuse by investment firms such as product mis-selling.

Investment firms are also required to keep records of the business carried out on behalf of clients. The Commission is proposing that this requirement should be extended to telephone conversations and electronic communications between the advisors and the client.¹²⁴ This information is to be provided to the client upon request.¹²⁵ It is argued that keeping a record of telephone conversations between advisors and the client enhances investor protection and is useful for supervisory purposes as it: **[i]** ensures that evidence exists to resolve disputes between an investment firm and its clients over the terms of transactions; **[ii]** assists with supervisory work in relation to conduct of business rules; and **[iii]** helps to deter and detect market abuse and to facilitate enforcement in this area.¹²⁶

Data protection concerns and privacy issues exist with regard to supervisory access to the content of telephone records and electronic communications. In this regard, while the E-Privacy Directive¹²⁷ and the Data Protection Directive¹²⁸ do not prevent the recording of telephone conversations and electronic communications, they however limit the circumstances in which recordings can be made and set certain safeguards on the handling of the recordings.¹²⁹ In order to address the data protection and privacy issues, the Commission has proposed that the access by financial supervisors should be

¹²³ Commission, 'Proposal for a Directive on markets in financial instruments repealing Directive 2004/39/EC', COM(2011)656, 20.10.11 (MiFID II Proposal), recital 52 and article 24. Political agreement between European Parliament and Council on MiFID II was reached on 14.01.14 <<http://goo.gl/xlydmZ>>accessed 05.03.14.

¹²⁴ MiFID II Proposal, article 16(7).

¹²⁵ MiFID II Proposal, article 16(7).

¹²⁶ CESR, 'Advice to the Commission: MiFID Review' CESR/10-859, 29.07.10 <<http://goo.gl/NxZ0yL>>accessed 15.03.14.

¹²⁷ Directive 2002/58/EC.

¹²⁸ Directive 95/46/EC.

¹²⁹ European Data Protection Supervisor, 'Opinion on the Commission Proposal for a Directive on markets in financial instruments repealing Directive 2004/39/EC (Recast)', 10.02.12 <<http://goo.gl/g8UJRU>>accessed 15.03.14.

limited to data traffic records and not to the specific content of telephone recordings and the records on electronic communications to which they relate.¹³⁰

Restricting the ability of financial supervisors to obtain information which could be relevant for supervisory, investigative and enforcement purposes, could damage their capability of fulfilling their duties.¹³¹ In this regard, the tensions that exist between the necessity of financial supervisors to have access to information on telephone conversations and electronic communications and the necessity of respecting the right for privacy and the safeguarding of personal data, attest to the difficulties that could surface in striking the right balance between achieving the objectives of financial regulation, while at the same time respecting the fundamental rights of society.

The proposed record-keeping requirement also raises possible issues of proportionality, as it does not distinguish between small-medium sized firms and large firms. It has been determined that the costs of implementing a requirement to keep a record of telephone conversations and retain such a record for a number of years may result in a considerable expense for small firms.¹³² However, in view of investor protection issues that might arise from telephone conversations between an advisor and his client; the importance of ensuring the same level of protection for all investors; and the EU's DeLarosiére policy decision of establishing a single rule book for financial services, it was determined that one record keeping requirement should apply across the board to all investment firms irrespective of the size of such firms.¹³³ This again demonstrates the possible tensions that could arise between achieving the objectives of financial regulation on the one hand and creating an equitable and proportionate regime on the other.

In addition to requiring financial institutions to act in the best interest of their clients by complying with detailed conduct of business and record keeping requirements, trust in a particular financial market is also a function of the extent and accuracy of the information provided to investors. Ensuring disclosure of information to investors which is sufficiently clear, comprehensible and comparable and which therefore assists

¹³⁰ MiFID II Proposal, article 71.

¹³¹ CESR (*n126*).

¹³² CESR (*n126*) 14-16.

¹³³ MiFID II Proposal, recitals 42 and 45.

an investor in making an investment decision is fundamental to mitigate the information advantage of financial institutions.¹³⁴ Therefore, it is reasonable to argue that mandatory disclosure requirements which compel the financial institution to issue pertinent information that would allow an investor to understand the basis for the investment advice and the relevant financial instrument should mitigate information asymmetries. This should in turn reduce the risk of market failures which may come about as a consequence of product mis-selling, as more informed investors should, *ceteris paribus*, be able to identify financial products which match their investment risk profile.

2.3.3 Safeguarding the Integrity of Financial Markets

Transparency therefore has a cardinal function. It militates towards the preservation of the integrity of financial markets by contributing to the fairness and efficiency of such markets. Therefore, to achieve financial market integrity one has to go beyond transparency and extend regulation to require fair and equitable trading and the prohibition of all forms of market abuse. In this regard, supervision of the financial markets to identify and take regulatory action against instances of market malpractice are critical functions to achieve the integrity of financial markets.

Financial markets play a critical role in economic development and financial stability. The crucial purpose of such markets is to serve as a device for the transformation of savings generated by the various members of society into financing for the business community.¹³⁵ In view of the important role which financial markets play, it is vital for such markets to operate properly and to transmit to all interested parties a sense of efficiency, integrity and transparency. Financial markets should consequently be able to provide investors with the opportunity of transacting in a fair and informed environment where prices reflect full and correct information issued by listed companies and the market.¹³⁶ However, given the potential for gains which may be generated through financial markets and the existing risks of asymmetries of information, such markets are very often vulnerable to abuse and manipulation. Market malpractice has the capacity of

¹³⁴ J Tanega, 'Credit Crisis Solutions: Risk Symmetric Criteria for Reconstruction of Socially Fair Asset-backed Securities' in *The Future of Financial Regulation* (Hart 2010) 233.

¹³⁵ A Carvajal and J Elliot, 'Strengths and weaknesses in Securities Market Regulation: A Global Analysis', (IMF 2007) 2<<http://goo.gl/7muE4C>>accessed 15.03.14.

¹³⁶ J Rydge, *The Importance of Market Integrity*, (SIRCA 2004) 7.

damaging the integrity and reputation of financial markets and as a result undermines the confidence that investors have in such markets and the financial industry as a whole. This sort of conduct may preclude a financial market from performing its fundamental function of bringing together buyers and sellers who are interested in trading financial instruments, especially when investors feel that they are not in a position to engage in transactions with confidence that they are acting on a level playing field.¹³⁷

The Transparency Directive ('TD'), the main purpose of which is the regulation of the disclosure of information by issuers of financial instruments, stipulates that:

[t]he disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance. This enhances both investor protection and market efficiency. ... To that end, security issuers should ensure appropriate transparency with investors through regular flow of information.¹³⁸

The application of proper transparency standards which require prompt disclosure of relevant information by publicly listed companies and the market is indeed fundamental to reduce the extent of asymmetric information, thereby reducing the possibility of market malpractice and contributing towards the integrity of the market.¹³⁹ This is one of the foundations of EU financial regulation that promotes the integrity of financial markets through several directives, such as the MiFID; the MAD;¹⁴⁰ the Prospectus Directive ('PD'),¹⁴¹ which regulates the prospectus to be published when securities are to be offered to the public or admitted to trading and the TD.

Ensuring that financial markets are transparent does not always correspond well with the objective of maintaining the stability of the financial system. The Northern Rock plc affair, whereby the announcement that this UK bank had requested for and had been

¹³⁷ J Hansen, 'What constitutes insider dealing? The AG's opinion in Case C-45/08, Spector Photo Group' (2009) <www.ssrn.com> accessed 27.08.11.

¹³⁸ Directive 2004/109/EC, recitals 1 and 2.

¹³⁹ M Siems, 'The EU Market Abuse Directive: A Case-Based Analysis', (2008) 2 Law and Financial Markets Review 42.

¹⁴⁰ Directive 2003/6/EC.

¹⁴¹ Directive 2003/71/EC.

provided with liquidity by the Bank of England, generated a run on the bank.¹⁴² In order to prevent such situations from occurring, the Governor of the Bank of England had indicated a preference for a covert liquidity operation, whereby Northern Rock plc would have been provided with the liquidity it required without a public announcement being made to the market. Yet, this was not possible given that as a publicly listed entity, Northern Rock plc was subject to transparency requirements, which in such circumstances required a public announcement to be made.¹⁴³ The announcement therefore had to be made even though there was a probability that this would have had possible negative consequences for Northern Rock plc and the UK banking system in general. This is indicative of the tensions that regulators and supervisors face in striking the right balance between the different objectives of financial regulation. It again demonstrates that fulfilling a fundamental objective of financial regulation could, at times, result in regulatory measures that weaken the realisation of other regulatory objectives.

Transparency on its own, however, is not enough to address all forms of market malpractice. Empirical evidence, derived from behavioural economics, demonstrates otherwise and reveals that very often the public is unable to properly process even simple information because of cognitive biases.¹⁴⁴ Therefore doubts still exist on whether transparency *per se* is an effective tool to achieve the objectives of financial regulation¹⁴⁵. It follows that in order to achieve optimum market integrity and investor protection, transparency must be complemented by other mechanisms such as the application of financial market intervention tools. Moreover, market abuse, which comes in the form of either the prohibited use of inside information or in the form of market manipulation, is considered as the primary type of market malpractice which threatens the integrity and efficiency of financial markets. This form of abuse cannot be effectively dealt with solely through the application of transparency requirements.

¹⁴² K Keasey and G Veronesi, 'Lessons from the Northern Rock Affair' (2008) 16(1) Journal of Financial Regulation and Compliance, 15.

¹⁴³ House of Commons, 'The run on the Rock - Fifth Report of Session 2007–08' 54–63 <<http://goo.gl/NPOkuu>> accessed 15.03.14.

¹⁴⁴ M Cipriani and A Guarino, 'Herd behaviour and contagion in financial markets' (2008) 1 The BE Journal of Theoretical Economics; and J Minor, 'Consumer Protection in the EU: Searching for the Real Consumer' (2012) 13(2) European Business Organization Law Review 163–168.

¹⁴⁵ A Etzioni, 'Is Transparency the Best Disinfectant?' (2010) 18(4) The Journal of Political Philosophy 389–404.

Company insiders, particularly company directors and senior management are exposed to non-public information about their organisation, some of which could be of a price sensitive nature; being information which a reasonable investor would be likely to use as part of the basis for his investment decision.¹⁴⁶ Company insiders can profit from such information by buying or selling their shares in the said company prior to the issue of the said information to the public. This can only be done at the expense of the uninformed investor. They can also pass on such information to other parties who would also have the opportunity to profit at the expense of genuine investors. While the prohibited use of inside information requires some form of intervention by a company insider, market manipulation does not necessitate such involvement and can be conducted through the creation of a false impression of trading activity or price movement or market information which leads to a distortion of the price formation process and in turn a reduction of market efficiency due to the fact that trading decisions are not made on financial fundamentals.¹⁴⁷

The primary rationale for the regulation of insider dealing and market manipulation is connected to market confidence and the perception of investors that the prices quoted on the market are fair and not distorted. It is worthwhile to point out that there are a number of theories which attempt to explain the rationale for the regulation of the prohibited use of inside information and market manipulation.¹⁴⁸ The Misappropriation Theory is based on the notion of ownership, where information is considered as the property of the source of the information (the company to which it relates) and the prohibited use of inside information is deemed to be a serious breach of the fiduciary relationship between the receiver of the information (a director) and the source of the information.¹⁴⁹ On the other hand, the Unfair Advantage Theory is based on the idea that markets should operate on the basis of complete equality between investors and

¹⁴⁶ B Rider and others, *Market Abuse and Insider Dealing*, (Butterworths 2002) 4.

¹⁴⁷ F Kristen, 'Integrity on European Financial Markets: Backgrounds, Objectives, Reasons, Overall Contents and Implications of the Market Abuse Directive' (2005) 1 *European Company Law* 19.

¹⁴⁸ Not all authors agree that the prohibited use of inside information should be regulated. Certain authors have theorised that insider trading is a 'victimless crime' in that there is no direct connection between the activities of an insider and the position of an investor who, as a result of those activities, pays for dealing in securities. Moreover, certain economists have also argued that insider dealing should be allowed, as it benefits a financial market given that active insiders ensure accuracy in the pricing of traded financial instruments by moving the price towards a level which correctly reflects the actual position of a company at a given point in time. See G Brazier, *Insider Dealing: Law and Regulation* (Cavendish 1996) 84-88.

¹⁴⁹ D Cohen, 'Old rule, New theory: Revising the personal benefit requirement for tipper/tipee liability under the misappropriation theory of insider dealing' (2006) 47(3) *Boston College Law Review* 555.

potential investors.¹⁵⁰ Trading should take place between parties who have equal rights and possibility of access to information. Lastly, the Market Stability Theory, which has certain similarities with the Unfair Advantage Theory, is based on the premise that flagrant prohibited use of inside information or market manipulation could seriously damage the confidence that investors have in financial markets which is largely based on the perception that financial markets are egalitarian, being the confidence that all investors have equal access to information on financial instruments traded on the market.¹⁵¹

In a financial market where market abuse prevails, there is a significant potential for misallocation of resources, as savings will not always be channelled to the most efficient organisations.¹⁵² Such abuse could significantly distort the price formation process of financial instruments traded on the said market, leading to inaccurate valuations of such instruments and the distribution of misleading post-trade information to the market. In a financial market where market abuse is rampant, liquidity providers such as market makers will protect themselves by increasing their selling price and decreasing their buy price which in turn affects the transaction costs on the market.¹⁵³ Once the investing public feels the impact of this and other consequences of market abuse, their willingness to actively participate in financial markets will decrease. In the short term, this lack of participation could undermine the liquidity and efficiency of such markets and increase the cost of capital for companies, while in the long run it could have serious repercussions on the stability, development and prosperity of the entire economy of a country or region as a whole. Therefore, the rationale behind relevant legislation such as the MAD, which prohibits market abuse, requires the investigation of suspicious transactions and the enforcement of market abuse, is that of safeguarding the smooth functioning of the financial market and investor confidence in the same. Both are considered as prerequisites for economic growth and wealth creation.¹⁵⁴ Regulation on its own is not enough to deter market abuse. Enforcement is of fundamental importance if this sort of market malpractice is to be discouraged.

¹⁵⁰ Brazier (*n148*) 83.

¹⁵¹ N Moloney, '*EC Securities Regulation*' (Oxford 2008) 924.

¹⁵² Siems (*n139*).

¹⁵³ G Ferrarini, '*The European Market Abuse Directive*' (2004) 41(3) *Common Market Law Review* 714.

¹⁵⁴ Directive 2003/6/EC, recital 2.

Prior to the financial crisis there was a general view that market abuse was widely practiced by financial market participants and that financial supervisors were not giving this area of financial regulation the attention and priority it deserves.¹⁵⁵ This reality was also acknowledged in the EU's DeLarosiére Report, which expressed concern regarding inadequate supervisory resources coupled with insufficient skills and weak sanctioning and enforcement regimes.¹⁵⁶ Experience in monitoring trading in shares on a financial market suggests that without credible deterrence, market abuse may become a common practice within a financial market.¹⁵⁷ The lack of coherent monitoring and enforcement of market abuse led the Commission to demand tougher action against this malpractice¹⁵⁸ and the initiation of a legislative process for the development of a proposal for the reform of the EU regulatory framework.¹⁵⁹

In practice, however, experience in carrying out investigations of suspected market abuse suggests that suspicions of this nature are not only difficult to prove but also very hard and costly to investigate.¹⁶⁰ However, the recent surge in enforcement action with regard to market abuse cases in Europe and the US indicates that following the financial crisis, addressing these cases has reached the top of the supervisory agenda.¹⁶¹ This is a reasonable reaction directed towards enhancing investor confidence in financial markets

¹⁵⁵ N Dorn, 'The metamorphosis of insider trading in the face of regulatory enforcement' (2011) 19(1) *Journal of Financial Regulation and Compliance* 77-78; also refer to A Hayes, 'Market Abuse' (2010) 75(Apr) *Compliance Officer Bulletin* 1-31.

¹⁵⁶ (n50) 23.

¹⁵⁷ The author is Deputy Director within the Securities and Markets Supervision Unit of the Malta Financial Services Authority and has several years of direct professional experience in policy, regulatory and supervisory matters in the field of securities regulation, including financial markets and the investigation of market abuse.

¹⁵⁸ N Tait, 'EU urges tougher action against market abuse' *Financial Times* (London 25.10.10).

¹⁵⁹ Commission, 'Public consultation on a revision of the Market Abuse Directive' Brussels, 26.06.10.

¹⁶⁰ (n157).

¹⁶¹ UK FSA, Annual Report 2010<www.fsa.gov.uk>accessed 29.08.11; Malta Financial Services Authority, 'Annual Report 2010'<www.mfsa.com.mt>accessed 29.08.11; 'The smartest guys in the room' *The Economist* online (London 12.05.11)<www.economist.com>accessed 29.08.11; A Duyn, 'Lessons of Galleon case go much wider than stocks' *Financial Times* (London 14.05.11) 15; B Masters, 'Trader fined pounds 1.1m for market abuse' *Financial Times* (London 25.05.11) 16; T Selby 'FSA fines trader pounds 700,000 for market abuse' *Money Marketing* (London 14.06.11)<<http://www.moneymarketing.co.uk/>>accessed 29.08.11; R Huseyin, 'Damages claims arise from Libor manipulation' (2013) 2(5) *Compliance and Risk* 18-19; M Alexander-Webber, 'JP Morgan fined \$920m for London whale losses' (2013) 14(10) *Operational Risk & Regulation* 7; P Scott, 'JP Morgan to \$100 Million in CFTC Pact on Whale Trades' *Wall Street Journal* (New York 15.10.13)<www.wsj.com>accessed 05.02.14; K Scannell, 'Rabobank agrees to pay \$1bn Libor fine' *Financial Times* (London 29.10.13)<www.ft.com>accessed 05.02.14; M Farrell, 'JP Morgan Adds \$2.6 Billion to its \$25 Billion plus tally of recent settlements' *Wall Street Journal* (New York 07.01.14)<www.wsj.com>accessed 05.02.14; K Scannell, 'NY Regulator Opens Currency Probe' *Financial Times* (London 05.02.14)<www.ft.com>accessed 05.02.14.

after the latter had received a serious blow as a consequence of the crisis. In the final analysis, it is reasonable to conclude that the policy response in this field and the action taken by financial supervisors, sustain the view that safeguarding and maintaining the fairness, honesty and integrity of financial markets in order to preserve investor confidence and the sustainability of such markets, continues to be one of the fundamental high-level objectives of financial regulation.

2.4 Conclusion

The financial system was created to serve the needs of society. In effect, the provision of financial services constitutes a public good and serves the common good by transferring savings to efficient organisations that require capital to invest. A stable financial system provides a favourable business environment for the efficient allocation of resources and by so doing supports job creation and economic growth. In theory, the financial system should be a means to an end and not an end in itself. The financial crisis points towards a different reality.

Attaining the high-level objectives of financial regulation is the means to ensure that the conduct of business of the financial system is controlled and does not threaten the welfare of society and the economy. Public interest is indeed the rationale for safeguarding systemic stability, protecting the investor and ensuring that markets are fair, efficient and transparent. In the aftermath of the financial crisis, the case for more effective financial regulation and supervision for the purpose of achieving these high-level objectives is undeniable. In the final analysis, it is natural to conclude that the financial crisis, the identified causes thereof and the policy response, based on a wide array of regulatory measures, have proven and sustained the continued validity and relevance of the theories and objectives of financial regulation.

Harmonised financial regulation and supervision, which achieve the objectives of financial regulation on a cross-border level, are a vital condition for the operation of mutual recognition in the field of UCITS. The analysis in this chapter serves as a prologue for the better understanding and the examination of the conditions and limitations of the governance mechanisms for mutual recognition and the outcomes of policy actions in the field of UCITS, which are analysed in chapters 3, 4 and 5.

Chapter 3

MINIMUM HARMONISATION OF REGULATION, HOME COUNTRY CONTROL AND MUTUAL RECOGNITION: A CRITICAL ANALYSIS OF THE FIRST TWO DECADES OF THE UCITS DIRECTIVE

3.1 Introduction

Chapter 3 examines the application of the principle of mutual recognition during the first two decades of the UCITS Directive. During this period, mutual recognition was contingent on minimum harmonisation of substantive regulation to achieve a uniform degree of investor protection for investors in UCITS and the application of the home country control and complementary host country supervisory principles. Each of these conditions for mutual recognition is examined. Two categories of limitations to mutual recognition emerge from the analysis. These are the limitations of the governance mechanism and the limitations of the regulatory framework.

The central argument of the chapter is that while the 1985 UCITS Directive was a necessary first step in the process for the development of an internal market for UCITS, the limitations of the governance mechanism for mutual recognition based on minimum harmonisation of regulation, in the form of inconsistent application of the Directive and the application of Member State discretions, raised barriers to the internal market for UCITS. In addition to the above-mentioned limitations of the governance mechanism, the first two decades of the 1985 UCITS Directive were also characterised by limitations of the regulatory mechanism for mutual recognition. These took the form of tight investment restrictions, and the prohibition on the management company and the depositary from providing cross-border services.

The chapter is divided into four additional sections. Section 3.2 critically examines the governance mechanism and the substantive regulation that surface from the 1985 UCITS Directive and identifies the conditions and limitations of mutual recognition

during this initial period of the Directive's existence. Section 3.3 analyses the failed UCITS II Proposal and the reasons why, at that stage, broader mutual recognition could not be achieved in the new fields proposed by the Commission. Section 3.4 critically examines the contribution of the 2001 UCITS III Directive towards widening of mutual recognition for collective investment schemes. Concluding remarks are made at the end of the chapter.

The analysis in chapter 3 is used to draw specific conclusions on the mechanisms for mutual recognition during the first two decades of the UCITS Directive. For this purpose, the evolution of substantive law for investor protection in the EU is also examined. In a number of instances reference is made to the US where federal regulation for the protection of investors in collective investment schemes was adopted forty-five years before the UCITS directive. This analysis is critical to the debate on the evolution of the conditions and limitations of mutual recognition and the development of the internal market for UCITS.

3.2 The Origins – The 1985 UCITS Directive

The first European proposal for the adoption of a Directive that regulates the activity of collective investment schemes and which would have granted these schemes access to the internal market, was first presented by the Commission in 1976.¹ Various factors are said to have triggered this development, including the 1966 Group of Experts Report to the Commission known as the 'Segre Report'. This report acknowledged the ability of collective investment schemes as saving agents for retail investors and suppliers of capital within the economy, both of which are necessary to invigorate the integration of the European financial markets.² Integration through the creation of an internal market for collective investment schemes would have increased the competition amongst operators in this field and, as a consequence, the efficiency of the industry.

At the time when the proposal for a UCITS Directive was made, a highly fragmented regulatory framework applied to collective investment schemes established in the EU.

¹ N Moloney, 'EC Securities Regulation' (Oxford University 2008) 245.

² Commission, 'The Development of a European Capital Market – Report by a Group of Experts Appointed by the EEC Commission' (1966) <<http://goo.gl/HnO2K4>> accessed 06.11.10.

Each Member State had its own regulatory framework for collective investment schemes, with major differences existing with regards to the on going obligations and controls imposed on such schemes in the different Member States.³ These differences distorted competition among schemes established in different Member States and created an uneven investor protection regime in Europe.

One may argue that the call for harmonisation of EU financial regulation was at that stage also based on the assumption that legal diversity causes transaction costs and lowers the incentive for retail investor to enter into cross-border transactions. Retail investors tend to refrain from contracts in foreign legal systems if the costs of information and/or the costs of enforcement seem too high or unpredictable.⁴ Against this background harmonisation of regulation becomes a tool to reduce individual information costs and general uncertainty because the complexity of acting declines. More coordination was therefore required if integration in this field was to be achieved.⁵

The objective of creating an integrated and efficient internal market for collective investment schemes, which would benefit retail investors and financial markets in Europe is clearly spelt out in the 1985 UCITS Directive:

... national laws governing collective investment undertakings should be coordinated with a view to approximating the conditions of competition between those undertaking at Community level, while at the same time ensuring more effective and more uniform protection for unit-holders; ... such coordination will make it easier for a collective investment undertaking situated in one Member State to market its units in other Member States ...

... the attainment of these objectives will facilitate the removal of restrictions on the free circulation of the units in collective investment undertakings in the

³ Commission, 'Toward a European Market for the UCITS – Commentary on the provisions of Council Directive 85/611/EEC of 20 December 1985' (Vandamme Report) <<http://goo.gl/K0iUzy>> accessed 15.03.14.

⁴ H Wagner, 'Is harmonisation of legal rules an appropriate target?' (2012) 33(3) European Journal of Law & Economics 541-564.

⁵ Vandamme (*n3*).

Community, and such coordination will help bring about a European capital market ...⁶

Therefore, the 1985 UCITS Directive aimed at achieving two broad outcomes: [i] the coordination of national regulation of collective investment schemes which would make it easier for such schemes to provide cross-border activity within the EU; and [ii] the establishment of harmonised substantive requirements which would result in uniform investor protection in Europe. This part of chapter 3, examines the mechanisms applied for achieving these two separate but interlinked outcomes and the extent to which these have contributed towards mutual recognition between Member States in the field of UCITS.

3.2.1 A Governance Mechanism for the Approximation of Regulation

Notwithstanding the deemed benefits of a Directive on collective investment schemes, reaching a compromise on the Commission's proposal within the Council turned out to be a challenging and protracted task. The negotiation process took nine years to complete. The Treaty establishing the European Economic Community required unanimity in Council for the adoption of internal market regulation, such as the 1985 UCITS Directive. Therefore, dogged blocking tactics triggered by narrow national interests could have easily obstructed progress in the discussions. As a consequence, such negotiations would generally result in a compromise based on the least common denominator.⁷ Indeed, to this day the argument against harmonisation is still made on the basis that in a world of divided political sovereignty and diverse national preferences, the push for harmonisation could end up being a recipe for compromises which result in weak and ineffective regulation.⁸

While the debate on the proposed UCITS Directive continued, a major step in the governance mechanism for the creation of an internal market for financial services was taken with the publication of what is generally referred to as the 1985 Cockfield White

⁶ Directive 85/611/EEC.

⁷ R Axelrod, 'The complexity of cooperation: Agent-based models of competition and collaboration' (Princeton University 1997).

⁸ D Rodrik, 'The case against international financial coordination' (2010) <www.project-syndicate.org> accessed 14.11.12.

Paper. This Paper set out for the first time a comprehensive list of what needed to be done to overcome the barriers to cross-border business which existed within the EU and established 31 December 1992 as the deadline for doing so.⁹ The aim of the 1985 Cockfield White Paper was that of dealing with the poor performance of the Community in achieving the internal market objective, which was largely due to the deficiencies in the governance mechanisms for financial regulation applicable at the time and the lack of political will on part of the Member States.¹⁰ The 1985 Cockfield White Paper suggested that in order to achieve an internal market in the field of financial services, the EU had to enact twenty pieces of legislation which *inter alia* had to cover the three principal areas of financial services. The list included the adoption of a directive to regulate the cross-border marketing of collective investment schemes and made direct reference to the Commission's UCITS proposal.¹¹

The 1985 Cockfield White Paper also recommended the adoption of a governance mechanism which would be applied in the structuring of the new regulatory framework for financial services.¹² It suggested that the proposed new European regulatory framework should operate on the basis of mutual recognition between Member States based on minimum harmonisation of regulation, home country control and complementary host country supervision.¹³ The 1985 Cockfield White Paper also recorded the importance of achieving supervisory convergence for the purpose of effective mutual recognition by stating that:

There would have to be a minimum harmonisation of surveillance standard, though the need to reach agreement on this must not be allowed to further delay the necessary and overdue decisions.¹⁴

⁹ Commission, 'Completing the Internal Market: White Paper to the European Council' COM(85)310, 14.06.85<<http://goo.gl/ZbgVVb>>accessed 15.03.14.

¹⁰ K. Armstrong and S. Bulmer, 'The Government of the Single European Market' (Manchester 1998) 303–304.

¹¹ P. Clarotti, 'The Completion of the Internal Financial Market: The Current Position and Outlook', in 'E.C. Financial Market Regulation and Company Law', (Sweet & Maxwell 1993) 82.

¹² E. Kapstein, 'Governing the Global Economy: International Finance and the State' (Harvard 1994) 129–154.

¹³ Commission (n9).

¹⁴ Commission (n9) 28.

The above suggests that while supervisory convergence had been identified as a condition for mutual recognition, reaching a compromise on a minimum standard for supervision at that early stage of the integration process would have proved to be a problematic task. Undoubtedly, attempting to achieve a minimum degree of supervisory convergence would have delayed the negotiations on the laws proposed in the 1985 Cockfield White Paper.

With regard to the process that led to the eventual adoption of the UCITS Directive, the points raised in the 1985 Cockfield White Paper to the Commission's UCITS Proposal, resulted in a push in the negotiations within the Council, which adopted the Directive on the 20th December of the same year.

The choice of a Directive as the legal instrument for the achievement of harmonisation in the field of collective investment schemes and the creation of an internal market for UCITS supports the view that, at the time, significant differences in the legal framework of the Member States in this field must have existed. Therefore, in order to come to a compromise on the text of the Directive, Member States could have required a certain degree of discretion with regard to implementation. It is generally accepted that the disposition of a Directive as binding EU legislation, which however allows for a certain degree of flexibility with regard to implementation, makes this legal instrument suitable for the approximation of laws throughout the EU.¹⁵ A Directive grants Member States the opportunity to shape the implementing legislation to their particular circumstances as long as the implementation fulfils and satisfies the aim of the Directive.¹⁶ Hence, harmonisation of national law through a Directive is compatible with and does not require a change to national legal traditions, legal techniques, doctrinal theories of law and ideological divergence.

Directives constitute two-phased type legislation. At the first stage the European Institutions adopt the Directive. Its provisions are aimed at achieving a particular result in all Member States. The second stage follows where each of the Member States transposes the content of the Directive into national law. It is the result of the

¹⁵ B Kurcz, 'Harmonisation by means of Directives – never-ending story?' (2001) 12(11-12) *European Business Law Review* 287–307.

¹⁶ C Buttigieg, 'Implementing CRD for investment firms: challenges for Malta' (2012) 20(4) *Journal of Financial Regulation and Compliance* 417-432.

transposition which gives rise to rights and obligations that can be invoked by interested parties in case of litigation. The fact that Member States are afforded the choice of forms and method of transposition in order to attain the objectives laid down in the Directive does not impact its binding character. Where a Member State fails to take the necessary measures to transpose and implement a Directive within the stipulated deadline, the said Member State would be in breach of its obligations under the Treaty and the Directive. This could be a basis for infringement proceedings against the Member State at fault.

It is common for Directives to be transposed and implemented differently in Member States. In this regard, it has been argued that Directives are not ideal legal instruments of harmonisation in terms of predictability of result.¹⁷ The use of Directives is synonymous with the granting to Member States of different options and discretions with regard to the application of particular provisions of the Directive. These would generally be negotiated during the debate in Council and have the purpose of catering for the particularities of the markets and legal traditions of the different Member States. As will be submitted in other parts of the thesis, given the flexible nature of a Directive, the implementation generally gives rise to different interpretations of its requirements by the Member States. This means that Directives are likely to be implemented inconsistently at the transposition stage and when they are applied in practical situations. This invariably triggers mutual distrust between Member States and the consequent raising of national barriers to cross-border activity.

The internal market for UCITS created by the 1985 UCITS Directive, was one of the first examples of European Community internal market legislation to come into force.¹⁸ It followed the governance model set by 1985 Cockfield White Paper. The principle of mutual recognition was applied, whereby a UCITS satisfying the conditions in its home Member State became entitled to engage in investment activities in any other Member State.¹⁹ The 1985 UCITS Directive is generally considered as a landmark in the creation of an internal market in the field of securities business, as it established, for the first

¹⁷ Kurcz (*n15*) 290.

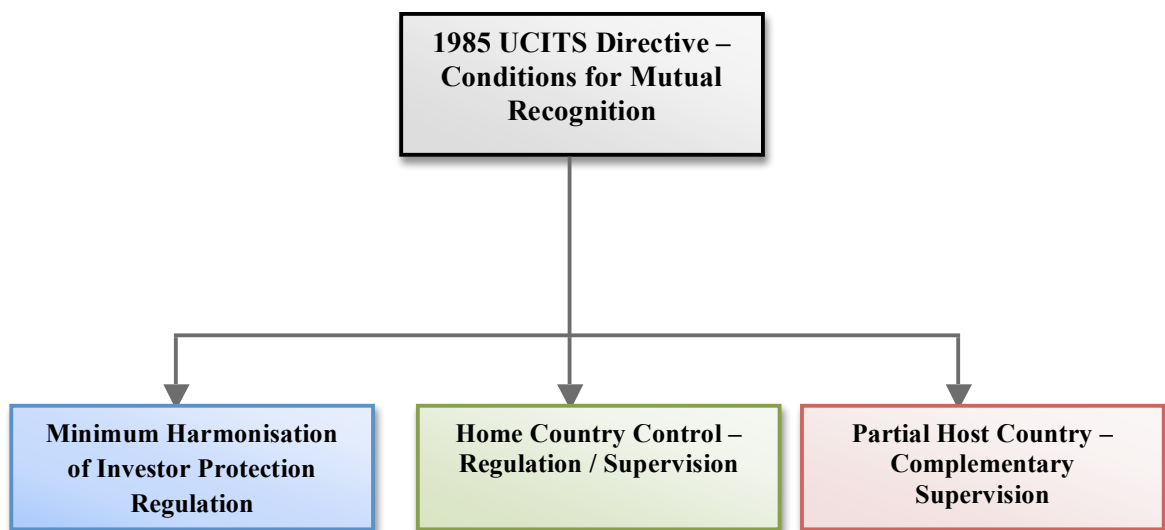
¹⁸ D Tunkel, 'The Internet and the European Single Market in Financial Services' (1996) 10 *Journal of International Banking and Financial Law* 485.

¹⁹ J Benjamin and A Holmes, 'The Evolving Legal Environment for Fund Management' (1996) 10 *Journal of International Banking and Financial Law* 480.

time, a framework for the application of mutual recognition in this field.²⁰ Indeed, it paved the way for the development of other internal market Directives dealing with financial services.²¹

Mutual recognition refers to a state of affairs whereby Member States recognise each other's regulatory framework and trust one another to carry out adequate supervision of a UCITS. Following the 1985 Cockfield White Paper doctrine, mutual recognition in terms of the UCITS Directive, was contingent on minimum harmonisation of investor protection rules, home country control and complementary host country supervision. Therefore, the UCITS Directive was adopted on the premise that respecting these three conditions for mutual recognition would allow the unhindered cross-border activity by UCITS.

Diagram 3.1 – Conditions for Mutual Recognition



Minimum harmonisation as a method for achieving integration requires that only the rules, that are essential for the functioning of the internal market should be harmonised.²² In this regard, the expression ‘at least’ is the most frequently used term in

²⁰ E Lomnicka, ‘The Home Country Control Principle in the Financial Services Directives and the Case Law’ (2000) 11(5) European Business Law Review 326.

²¹ E Wymeersch, ‘The European community’s action in the area of transferable securities’ (1988) 3 International Business law Journal 372.

²² D Curtin, ‘European Legal Integration: Paradise Lost?’ in D Curtin, J Smits, A Klip, and J McCahery (eds), *European Integration and Law: Four Contributions on the Interplay between European and*

Directives to indicate a minimum level of harmonisation to be pursued by the implementing authority. In other instances, such as in the case of the 1985 UCITS Directive, the nature of the Directive is also explicitly stated in the text by granting Member States the discretion of applying within their territory, requirements which are stricter than or additional to those set in the Directive.²³ Therefore, minimum harmonisation occurs where EU law lays down a floor of common rules leaving Member States free to retain or apply other measures that result in more stringent standards.²⁴ This freedom is extended to the ceiling set by the provisions of the Treaty.

In the context of 1985 UCITS Directive, the imposition of minimum standards to be applied in every Member State had the purpose of providing for a certain degree of equivalent investor protection safeguards for consumers of financial services throughout Europe²⁵, while at the same time allowing a certain degree of flexibility with regard to the constitutional framework for the establishment of the UCITS and other national regulatory traditions. One may argue that in the context of mutual recognition, minimum harmonisation meant that the credibility of the host Member State's regulatory framework to the home Member State, lay in the fact that the host Member State regulation contained familiar minimum standards which were also applicable in the home Member State. Where the application of the minimum standards by the Member States became distorted due to different interpretations of the provisions of the Directive, their value for the purpose of mutual recognition diminished.

The 1985 Cockfield White Paper determined that minimum harmonisation *per se* was not going to permit mutual recognition to operate properly. Without a governance mechanism which regulates the shared supervision of the passporting UCITS, the cross-border marketing of UCITS would have continued to entail the application of the regulatory frameworks of the home Member State and that of host Member States. Therefore, minimum harmonisation had to be complemented by the home country control principle. This principle became the primary governance structure for the

National Law to Celebrate the 25th Anniversary of Maastricht University's Faculty of Law (Intersentia Antwerpen, 2006) 12.

²³ Directive 85/611/EEC, article 1(7).

²⁴ F DeCecco, 'Room to Move? Minimum Harmonization and Fundamental Rights' (2006) 43(1) Common Market Law Review 9-30.

²⁵ D Pope and L Garzaniti, 'Single Market-Making: EC regulation of securities markets' (1993) 14(3) Company Lawyer 44.

regulation and supervision of UCITS and sought to remove part of the barrier to cross-border financial services, by establishing the home Member State as the lead regulator for the financial entity, responsible for authorisation and on-going supervision and granting the host Member State complementary supervisory powers.²⁶

As a result, once a UCITS was authorised by its home Member State, that same authorisation was valid for all the other Member States and, subject to the making of a passporting notification, the authorised UCITS could be marketed in all the other Member States. In terms of process, once a passporting notification was made to the host Member State, that State had two months within which to process the notification. As a condition for access to the host Member State, a passporting UCITS was required to comply with the national marketing rules of that State.²⁷ Under these rules the host Member State could *inter alia* regulate marketing techniques, publicity and distribution infrastructure. The host Member State was also granted the power to monitor the passporting UCITS's degree of compliance with those rules.²⁸ The host Member State could for instance object to the marketing by a passporting UCITS, if it considered that the arrangements made for marketing in the host Member State did not comply with the local regulatory framework.²⁹

In certain instances, the application of the procedure for passporting of a UCITS and the application of national marketing rules created a regulatory barrier to the cross-border activity of UCITS. Certain Member States exercised such discretion to render applicable national market rules, as an opportunity to enact registration procedures for passporting UCITS. This, in practice, placed real constraints on the benefits of the European passport of UCITS.³⁰ On different occasions the Commission stated that:

... difficulties have arisen in respect of [the] smooth functioning [of the passport]. ... the formalities, length and complexity of the notification procedure may vary greatly from one Member State to the other. If some of these variations can be explained by different administrative practices, many of them

²⁶ Lomnicka (*n20*) 326.

²⁷ Directive 85/611/EEC, article 44.

²⁸ Directive 85/611/EEC, article 49.

²⁹ Directive 85/611/EEC, article 46.

³⁰ X Freixes, 'Spain: Disclosure of Information to Investors in Foreign Collective Investment Schemes' (1997) 10 *Journal of International Banking and Financial Law* 492.

also result from diverging interpretations of the Directive.³¹

... Procedures for cross-border marketing are cumbersome, costly and subject to undue supervisory interference. Directive deadlines for completing review of fund notifications have frequently been exceeded. Difficulties have also taken the form of intrusive checks of the UCITS during the notification procedure, additional information requirements or requests to modify documentation or certain fund features (e.g. name/denomination of fund). These difficulties undermine the effectiveness and credibility of the fund passport. ...³²

Thus the granting of national discretions to the Member States, such as the discretion to apply national marketing rules in the host Member State, coupled with inconsistent interpretation and implementation of the Directive, distorted the functioning of mutual recognition in terms of the 1985 UCITS Directive. In certain instances, the intervention of the host Member States went beyond what was allowed by the 1985 UCITS Directive. On a number of occasions the host Member States prevented the marketing of units of a passporting UCITS because its features were deemed as not being compliant with the requirements of the Directive.³³ Such action was clearly in breach of the Directive which only allowed the host Member State to review at notification stage the compliance of a UCITS from another Member State with the laws, regulations and administrative provisions applicable to marketing arrangements falling outside the field governed by the Directive.

While national barriers to cross-border activity were generally presented as means of ensuring a higher standard of protection for the local investment community, in certain instances, these were clearly exercised with the aim of protecting the local industry from potential competition originating from other Member States.³⁴ Therefore, the manner in which national discretions are exercised and the inconsistent implementation and

³¹ Commission, 'Interpretative Communication: Respective powers retained by the Home State and the Host State in the marketing of the UCITS pursuant to the UCITS Directive' COM(2007)112, 19.03.07 <<http://goo.gl/sw44xI>>accessed 15.03.14.

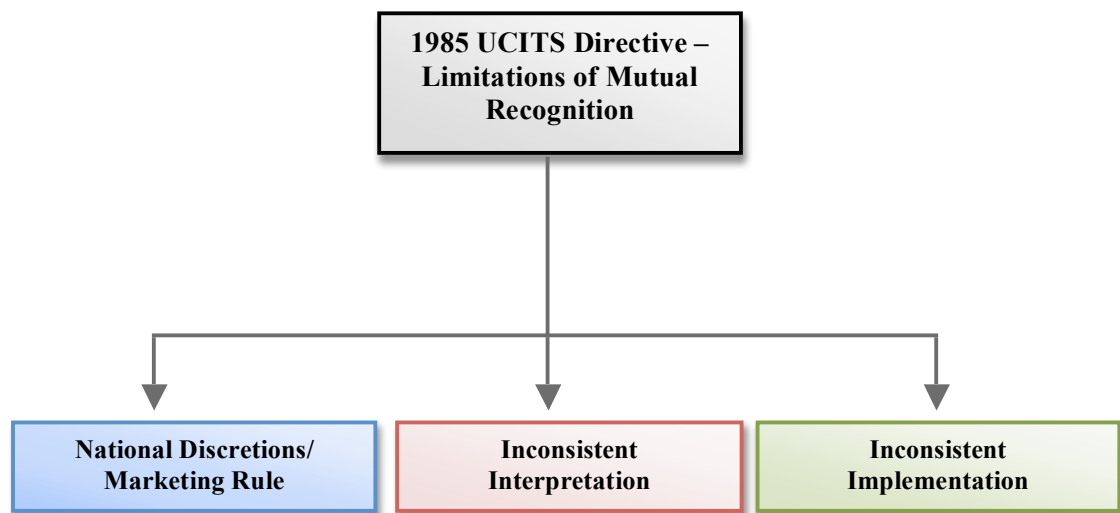
³² Commission, 'Impact Assessment: Proposal for a Directive on the coordination of laws, regulations and administrative provisions relating to UCITS, SEC(2008)2263<<http://goo.gl/6KaaFh>>accessed 15.03.14.

³³ This information was obtained during the interviews held for the purpose of the thesis. For further information, see the methodology section in chapter 1 and annexes 1 and 2.

³⁴ (n33)

interpretation of the Directive, are three significant limitations of the governance mechanism for mutual recognition, based on minimum harmonisation of regulation, home country control and complementary host country supervision. As analysed in other parts of this thesis, the internal market concerns arising from the granting of national discretions to Member States and the inconsistent application of EU regulation still exist and continue to sustain the identified limitations of mutual recognition as a tool for the completion of the internal market for UCITS.

Diagram 3.2 – Limitations of the Governance Mechanism for Mutual Recognition



In order to support the operation of the home country control principle, the 1985 UCITS Directive attempted to create a legal mechanism to facilitate cooperation within the internal market for UCITS. The Directive required the home and the host financial supervisors to collaborate closely in order to carry out their tasks and for this purpose to communicate to each other all relevant information.³⁵ This requirement was rather broad, vague and provided limited guidance on the situations where supervisory cooperation would have been required and the mechanism which should have been applied in this regard. Moreover, the host financial supervisors were not always prepared to trust the supervision carried out in the home Member State. Nonetheless, given that cross-border activity at the stage when the directive was being adopted was limited to the marketing of the UCITS, one may argue that the legislator must have considered this basic requirement of cooperation as sufficient to trigger collaboration

³⁵ Directive 85/611/EEC, article 50.

between the financial supervisor of the home Member State and that of the host Member State where necessary.

As a means of ensuring a certain level of integration with regards to the implementation of the 1985 UCITS Directive and cooperation between financial supervisors in different Member States, the Directive established the UCITS Contact Committee. This was eventually replaced by the Committees developed as part of the Lamfalussy process. The Contact Committee was given the mandate to facilitate the harmonised implementation of the Directive and the cooperation between Member States and to advise the Commission on additions or amendments to the Directive.³⁶ It is fair to argue that the establishment of the Contact Committee was the first European attempt to attain enhanced cooperation and convergence in financial supervision and therefore a very important first step for the development of the European governance structure for the supervision of European securities business. This said, it is also true that throughout the years when this Committee was in existence, the internal market for UCITS was characterised by inconsistency in the application of the UCITS Directive and lack of cooperation between financial supervisors. It follows that the Contact Committee was not an effective governance mechanism to achieve the high-level objective of enhancing cooperation and convergence with regards to the application of the UCITS Directive.

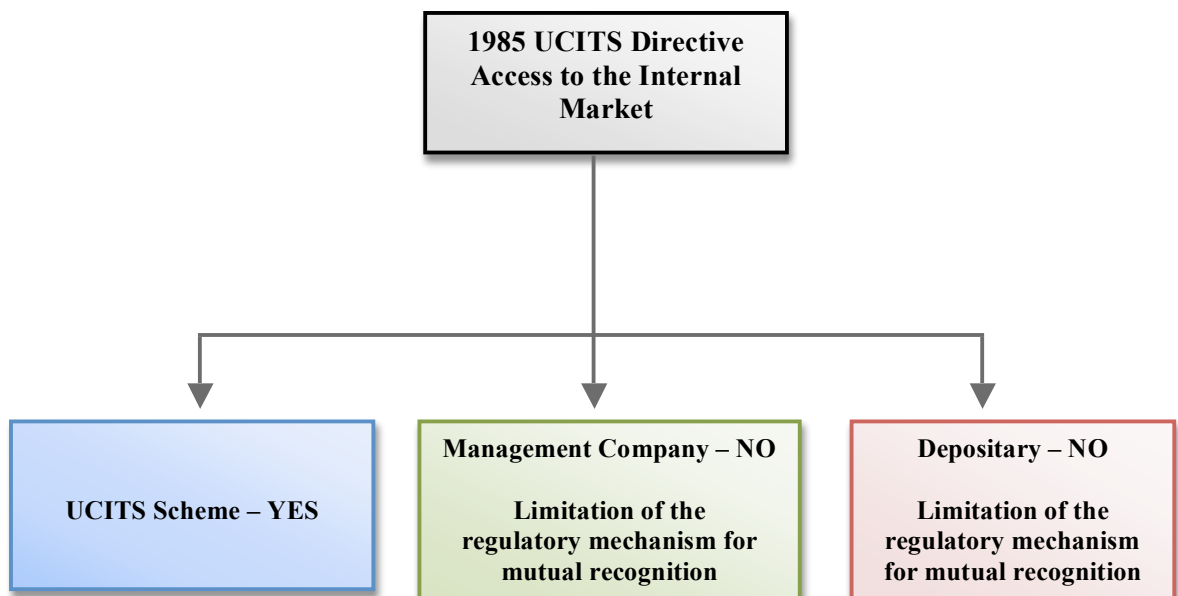
Apart from developing the governance mechanism for the effective application of the conditions for mutual recognition, the main challenge facing the European legislator, with regard to the drafting of the 1985 UCITS Directive, was that of making a correct decision in respect of the right combination of elements of substantive regulation for investor protection that would have allowed mutual recognition between the Member States to operate effectively.

³⁶ Directive 85/611/EEC, article 53.

3.2.2 Minimum Substantive Regulation for Investor Protection

The framework set in the 1985 UCITS Directive was mainly directed towards the regulation of the product as opposed to the management company and the depositary of the UCITS. The rationale behind this approach was that while the UCITS was granted access to the internal market, the 1985 UCITS Directive did not permit the management company and the depositary to provide cross-border services in other Member States. In terms of the 1985 UCITS Directive these service providers were required to be established in the same Member State as that of the UCITS. This meant that the management company and the depositary could not provide services to UCITS established in other European jurisdictions. This limitation meant that minimal harmonisation of the regulation of the organizational and conduct of business requirements applicable to the management company and the depositary was required at this stage. This made a compromise in Council for the adoption of the Directive more achievable.

Diagram 3.3 - Access to the Internal Market.



The regulation of collective investment schemes is primarily aimed at addressing investor protection concerns. These come in the form of conflicts of interest as well as the asymmetry in market power and information that might arise due to the various principal-agent relationships that exist in a collective investment scheme structure. The

simplest form of abuse of the principal-agent relationship occurs where the management company makes false representations in respect of the value of the assets in the portfolio of the collective investment scheme, with the aim of generating higher fees, in cases where fees are calculated as a percentage of the value of the assets of the scheme.³⁷ Regulation would generally attempt to mitigate the various sources of principal-agent investor protection concerns through organisational, conduct of business and transparency requirements applicable to the various parties that form part of a collective investment scheme structure and through the application of prescriptive restrictions regarding the asset allocation of such schemes.

At the time when the 1985 UCITS Directive was being drafted and debated the above-mentioned principal-agent investor protection concerns were not new. These concerns had already been addressed at a much earlier stage in the US through the adoption of the Investment Companies Act of 1940³⁸ ('ICA 1940'). The Act has the purpose of mitigating as far as possible the conditions that may arise within a collective investment scheme that may adversely affect the interest of investors. The ICA 1940 was enacted to address the market malpractice at the detriment of investors that occurred within the investment fund industry during the late 1920's and the 1930's and which were identified by the SEC post the crisis of 1929.³⁹ During this period investors in collective investment schemes suffered severe losses, a substantial portion of which was a direct result of the mismanagement and manipulation within the industry. The public dissatisfaction provoked by these losses was exacerbated by a series of failures of collective investment schemes, due to fraud and misappropriation by management, and by substantial evidence that many schemes were serving as vehicles for practices which,

³⁷ J McCallum, 'Mutual fund market timing: A tale of systemic abuse and executive malfeasance' (2004) 12(2) *Journal of Financial Regulation and Compliance* 170–177.

³⁸ For an analysis of investor protection under the ICA 1940 see: W Motley, C Jackson and J Barnard, 'Federal Regulation of Investment Companies since 1940' (1950) 63(7) *Harvard Law Review* 1134–1156; and A Rosenblat and M Lybecker, 'Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project' (1976) 124(3) *University of Pennsylvania Law Review* 587–686; and SEC, 'Protecting Investors: A Half Century of Investment Company Regulation' (1992) SEC Division of Investment Management <<http://goo.gl/OUYcNs>> accessed 17.02.14

³⁹ For an examination of the sequence of events that lead to the adoption of the ICA 1940 see: C Bosland, 'The Investment Company Act of 1940 and Its Background' (1941) 19(4) *Journal of Political Economy* 477–529; Yale Law Journal, 'The Investment Company Act of 1940' (1941) 50(3) *Yale Law Journal* 440–457 and Columbia Law Review 'The Investment Company Act of 1940', (1941) 41(2) *Columbia Law Review* 269–295.

if not actually illegal, were nonetheless disregarding the best interests of investors.⁴⁰

The public discontent in the US resulted in a mandate to the SEC to investigate the industry and report its findings and recommendations to Congress.⁴¹ The SEC report, published in three parts between 1938-1940, revealed many different forms of principal-agent malpractices and made the point that these occurred as a result of the very nature of collective investment schemes. Specifically, that the same persons were involved in all activities of the scheme and thus exercised a significant degree of control over its functions and could, as a consequence, easily manipulate its assets.⁴² Given the serious concerns about the activities of collective investment schemes the SEC persisted in its desire to bring the activities of such entities under federal control.⁴³ Consequently, the ICA 1940 requires collective investment schemes in the US to register with the SEC, which is responsible for their regulation and supervision, and also makes such schemes subject to diversification, custody and disclosure requirements.⁴⁴

Hence, while the push in the US for federal regulation of collective investment schemes was triggered by concerns about market confidence, the European drive for supranational regulation of the same field was generated by a desire to liberalise markets and, as a result, benefit from efficiency and economic growth. Even so, the mechanism applied to achieve these two distinct objectives was the same. Indeed, so crucial is the protection of the investor for the proper functioning of the investment industry that without such regulation neither the regaining of market confidence in the US after the financial debacle of 1929, nor mutual recognition between Member States in fields such as UCITS, would have been possible.

Investor protection is however not the only objective that triggers the adoption of regulation of the activity of collective investment schemes. Regulation of collective investment schemes may, at times, also seek to address the possible systemic risk

⁴⁰ (n38)

⁴¹ Report on the Study of the Securities and Exchange Commission on Investment Trusts and Investment Companies pursuant to Section 30 of the Public Utility Holding Company Act of 1935 (1938-1940) <<http://goo.gl/7LP5jq>>accessed 15.03.14.

⁴² (n41)

⁴³ J Seligman, 'The Transformation of Wall Street: A history of the Securities Exchange Commission and modern corporate finance' (Aspen 2003) 222-229.

⁴⁴ J Cox, R Hillman, D Langevoort, '*Securities Regulation: Cases and Materials*' (Wolters Kluwer 2013), chapter 'The Investment Advisers and Investment Company Acts of 1940' 1077-1114.

implications arising from the failure of the collective investment scheme or from the conduct of the management company or depositary of the scheme. A collective investment scheme may become systemically relevant as a consequence of the nature of investment transactions it carries out, the amount and type of counterparties with which it performs its business, the extent of liquidity it requires and its overall financial position. In the absence of adequate regulation, collective investment schemes have the potential of creating instability within the financial system.⁴⁵ However, at the time of adoption of the 1985 UCITS Directive, systemic stability objectives of financial regulation were largely ignored. In fact, the Directive clearly indicates that the main objective of the Directive with regard to the harmonisation of substantive regulation was that of achieving a uniform protection of investors.

An examination of the substantive regulation set in the 1985 UCITS Directive, brings to light various measures for the protection of investors. For the purpose of this analysis these requirements have been classified into three categories: **[i]** general requirements; **[ii]** restrictions on the management company; and **[iii]** appointment of an independent depositary.

General Requirements

The 1985 UCITS Directive stipulates common minimum substantive requirements on the authorisation, supervision, structure and activities of UCITS and the information to be provided to their financial supervisors.⁴⁶ A requirement for authorisation is generally a means of exerting a certain degree of control over persons who are allowed to participate actively in the financial system,⁴⁷ thereby ensuring that only individuals who are deemed to be fit and proper, and therefore competent, honest and solvent, get involved in the management and administration of financial institutions. A requirement

⁴⁵ S Picciotto and J Haines, 'Regulating Global Financial Markets' (1999) 26(3) *Journal of Law and Society* 351–368; E Avgouleas, 'The Global Financial Crisis, Behavioural Finance, and Financial Regulation In Search of a New Orthodoxy' (2009) 9(1) *Journal of Corporate Law Studies* 23–59; G Rodriguez Paez, 'LTCM and other major hedge fund failures: Part 1' (2009) 24(5) *Journal of International Banking Law and Regulation* 244–251; E Ferran, 'The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis' (2011) Working Paper No176/2011 <www.ssrn.com> accessed 01.09.12.

⁴⁶ Directive 85/611/EEC, recital 4.

⁴⁷ IOSCO, 'Objectives and Principles of Securities Regulation', (2010) Principle 11 <<http://goo.gl/xMZ7kf>> accessed 15.03.14.

to be authorised also seeks to ensure that the applicant has a business plan and internal structure which is commercially sound and viable and that it affords proper protection to investors and does not threaten the soundness of the financial system. The regular reporting and supervisory requirements aim at guaranteeing that this remains the case on an on-going basis. These are all fundamental requirements, which are generally established in any regulatory framework applicable to financial services.

With regard to structure of the UCITS, the 1985 UCITS Directive stipulated that the UCITS could be constituted as either an investment company or a common fund, being a contractual fund or a fund constituted under trust law.⁴⁸ Nonetheless, whichever constitutional set up was to be adopted, the UCITS always had to be an open-ended scheme, which provides investors with the opportunity to redeem the units purchased.⁴⁹ An open-ended scheme would generally be open to create new units to satisfy subscriptions in the UCITS and to cancel units when redemption requests are made. Providing frequent opportunities to dispose or redeem a financial instrument provides investors with regular chances to invest and also to obtain liquidity when this is required. This is considered critical for retail investor protection purposes, as it would generally allow an investor who requires immediate access to his funds an easy route to get his money back. This option is generally not available where the scheme is closed-ended.

Restrictions on the management company

The 1985 UCITS Directive contained very minimal conditions applicable to the organisation of the management company appointed to manage the assets of the UCITS.⁵⁰ The Directive stipulated that the management of the UCITS had to be carried out either by a UCITS management company or by the board of directors of the UCITS if this had been organised as a self-managed investment company.⁵¹ The UCITS management company had to have sufficient financial resources to conduct its business and was prohibited from undertaking activities other than the management of collective

⁴⁸ Directive 85/611/EEC, article 1 (3).

⁴⁹ Directive 85/611/EEC, article 1 (2).

⁵⁰ Wymeersch (n21) 391.

⁵¹ Wymeersch (n21) 388.

investment schemes.⁵² The rationale behind the latter requirement is believed to have been that of providing investors with a high degree of protection by ensuring an optimum level of specialisation by the management company and avoiding all possible risks of a conflict of interest arising between the specified activity and others.⁵³

The 1985 UCITS Directive required that the sole object of the UCITS had to be the investment in transferable securities.⁵⁴ These were defined in the preamble as financial instruments admitted to official listing on a stock exchange or dealt in on a regulated market which operates regularly, is recognized and open to the public. Therefore, subject to certain limited exceptions such as the use of derivatives for hedging purposes, a management company was only allowed to invest the UCITS in securities, which were officially listed on stock exchanges or similar regulated markets.⁵⁵ Requiring the UCITS to invest only in transferable securities was a means of ensuring that the assets in which the UCITS invested had the degree of liquidity, which would allow the UCITS to meet the redemptions at the investors' request.

The 1985 UCITS Directive also set certain minimum risk spreading investment restrictions, which had the purpose of ensuring that the assets of the UCITS were well diversified.⁵⁶ This is another standard retail investor protection measure. In financial regulation, the setting of risk spreading investment restrictions seeks to guarantee that the management company of the UCITS invests the assets of the UCITS in a manner which reflects its profile, objectives and policies whilst at the same time achieving a certain degree of diversification, which mitigates primarily the risks relating to concentration and large exposures.

In the US, one of the main objections to the conduct of many collective investment schemes, prior to the enactment of the ICA 1940, was that investors were left in complete ignorance on the manner in which the scheme was being managed.⁵⁷ Units of the schemes were sold to the general public by emphasising the diversification and

⁵² Directive 85/611/EEC, article 5 & 6.

⁵³ Vandamme (n3).

⁵⁴ Directive 85/611/EEC, article 1 (2).

⁵⁵ Directive 85/611/EEC, recital 6 and article 19, 21 & 22.

⁵⁶ Directive 85/611/EEC, article 23, 24 & 25.

⁵⁷ (n39)

expert management of investments.⁵⁸ Prompted by such opportunities and enticed by names and literature suggesting that collective investment schemes were in a class with banks, investors put their savings in such schemes, only to learn later that the expected diversification and that the expertise of the managers was false and that their savings had been employed for the advantage of insiders.⁵⁹ The ICA 1940 addressed these investor protection concerns by way of specific requirements on diversification, conflicts of interest and transparency.⁶⁰

Diversification is not mandatory in terms of the ICA 1940. However, if a collective investment scheme elects to be diversified then in terms of the ICA 1940 the scheme would be subject to very detailed and strict diversification rules.⁶¹ To address the possibility of conflicts of interest the ICA 1940 contains a number of strong and detailed prohibitions on transactions between affiliates.⁶² As for transparency the ICA 1940 requires the scheme to have a prospectus, describing the fund, its objectives, its portfolio, its management, its per share record of investment performance, the sales charge and the costs of management.⁶³ Moreover, sales literature itself is regulated as to form and content by the SEC.⁶⁴

It is reasonable to suggest that some of the above-mentioned requirements may have served as a source of inspiration with regard to the drafting of the 1985 UCITS Directive. In this connection, with regard to transparency, the 1985 UCITS Directive stipulated substantive requirements on disclosure to investors by the UCITS. This entailed the publication of purchase and redemption prices, a prospectus, an annual financial report and a half-yearly financial report. Transparency requirements are one of the primary tools in financial regulation for the protection of the investor. Transparency regulation ensures that the investor is provided with the opportunity to make an informed investment decision, thereby seeking to reduce the extent of asymmetric

⁵⁸ E.P.R. 'Regulation of Investment Companies' (1940) 88(5) *University of Pennsylvania Law Review and American Law Register* 592.

⁵⁹ Bosland (*n*39) 512.

⁶⁰ Rosenblat and Lybecker (*n*38).

⁶¹ Investment Company Institute ('ICI'), 'Market Access For Regulated Fund Managers in the United States and the European Union' October 2013 <www.ici.org/pdf/27643.pdf> accessed 17.02.14.

⁶² Cox et al (*n*44) 1095.

⁶³ N Lobell, 'The Mutual Fund: A Structural Analysis' (1961) 47(2) *Virginia Law Review* 181-217 and Cox et al (*n*44) 1093-1094.

⁶⁴ Lobell (*n*63).

information between investors and the financial institution which is promoting and selling the UCITS.

It is reasonable to conclude that: **[i]** the investment restrictions applicable to UCITS that restricted investments to transferable securities and which therefore excluded collective investment schemes that invested in other types of assets from the internal market framework; and **[ii]** the limited substantive regulation applicable to management companies, which were not allowed access to the internal market; while suitable measures to kick start the internal market for collective investment schemes, were subsequently recognised as limitations of the regulatory mechanism for mutual recognition.

As will be examined in subsequent parts of this thesis, these limitations of the regulatory mechanism for mutual recognition were addressed in subsequent changes to the Directive, which were made with the purpose of ensuring a more extensive degree of mutual recognition between Member States and therefore a smoother operation of the internal market for UCITS.

Appointment of an Independent Depositary

The UCITS was required to appoint and entrust all its assets to a depositary⁶⁵, as an independent entity from the Scheme and the management company, which is subject to prudential regulation. The depositary was also required to monitor the activity of the management company. The requirement to appoint a depositary is an investor protection type measure. It seeks to address the principal-agent concerns which may arise within a collective investment scheme structure, by creating a controlling mechanism which should ensure that the assets of the UCITS are not abused by the management company. Such requirements came in the wake of the 1960's Investor Overseas Services Ltd scandal, wherein the assets of a collective investment scheme were used by one of this company's controlling parties for his own benefit.⁶⁶ So as to guarantee that the depositary carries out his safekeeping and monitoring duties effectively, the 1985

⁶⁵ Directive 85/611/EEC, articles 7 and 14.

⁶⁶ Time, 'Scandals: One of the largest frauds' *Time Magazine* (11.12.72) <www.time.com> accessed 14.11.10; See also B Scott Quinn, 'EC Securities Markets Regulation' in B Steil, *International Financial Market Regulation* (Wiley, 1994) 148.

UCITS Directive also stipulated that a depositary should be liable in case of losses suffered by the UCITS as a result of the unjustifiable failure of the depositary to perform its obligations or its improper performance of them.⁶⁷

In the US the investment adviser has, by and large, the same role as that of the management company in the EU. It typically organises the establishment of the collective investment scheme and is responsible for its overall operations. The adviser generally provides the seed capital, officers, employees, and office space, and usually selects the initial board of directors. As a result of this extensive involvement, and the general absence of shareholder activism, investment advisers typically dominate the funds they advise.⁶⁸ In order to limit the chances for misuse of the assets of a collective investment scheme by the investment advisor, the ICA 1940 requires schemes to maintain custody of funds assets separate from the assets of the investment advisor.⁶⁹ In addition an investment advisor with custody of client assets is required to take a number of steps designed to safeguard those client assets, which include the maintenance of such assets with a qualified custodian.⁷⁰ For this purpose a bank is normally engaged to act as custodian.⁷¹

The duties of the custodian in terms of the ICA 1940 are limited to safekeeping, including the reconciliation of the assets of the scheme⁷², and do not extend to the monitoring of the investment advisor as in the case of the depositary of a UCITS. In first instance this may suggest that the UCITS Directive affords a higher degree of protection to the investor when compared to the ICA 1940. Nonetheless, an examination of the role of independent directors of a fund registered under the ICA 1940 suggests otherwise, as these directors are specifically required to act as ‘independent watchdogs’ guarding the

⁶⁷ Directive 85/611/EEC, articles 9 and 16.

⁶⁸ C Randall, ‘Fiduciary Duties of Investment Company Directors and Management Companies Under the Investment Company Act of 1940’, (1978) 31 Oklahoma Law Review 635.

⁶⁹ T Frankel and A Schwing, *Regulation of Money Managers: Mutual Funds and Advisers* (Aspen Publishers 2000–2014 Supplement) chapter ‘Directors, Officers, Depositors, Custodians’.

⁷⁰ R Plaze, ‘Regulation of Investment Advisers by the US Securities and Exchange Commission’ (Stroock 2013) <<http://goo.gl/k1olJu>> accessed 02.03.14.

⁷¹ ICI, ‘Investment Company Fact Book’ (2013) <http://www.ici.org/pdf/2013_factbook.pdf> accessed 06.03.14.

⁷² ICI (n71) 222.

interests of investors.⁷³ The directors are required to monitor the overall management of the scheme, perform a robust review of, among other things, the nature and quality of the services provided by the adviser, and are responsible for policing operational conflicts between the interests of the investors and that of the investment adviser.⁷⁴ For this purpose investment advisers are required to provide the directors with all the information they require in order to be in a position to fulfill this role. Therefore, the ICA 1940 establishes a system of checks and balances through its reliance on independent directors to provide oversight of the investment advisers that manage the collective investment schemes. As a result of their specific monitoring role, independent directors would seem to offer significant protections to investors from possible abuse by the investment adviser. In general these protections would appear to be comparable to those afforded by a depositary under the UCITS Directive.

As already indicated, the 1985 UCITS Directive also required the depositary to be established in the same Member State of the UCITS.⁷⁵ At the time it was considered important for the governance of financial supervision that national financial supervisors, which had the responsibility of authorising the fund and the management company, to also have competence for the supervision of the depositary.⁷⁶ Proximity of the depositary to the fund manager and the scheme was also considered important for the proper fulfilment of the depositary's monitoring duties.⁷⁷ However, the requirement that the depositary had to be established in the same Member State of the UCITS was interpreted in a variety of ways.⁷⁸ The most onerous interpretation was that of Spain, which demanded the depositary to have its registered office and central administrative office in Spain. The same requirement was very broadly interpreted in Belgium, to the extent that it did not require the depositary to be incorporated in the EC. This is but one of a number of areas where the UCITS Directive was interpreted and applied inconsistently by Member States and provides yet another example of a limitation to the governance mechanism for mutual recognition in terms of the 1985 UCITS Directive.

⁷³ E Brodsky and M Adamski, *Law of Corporate Officers and Directors: Rights, Duties and Liabilities*, 2012-2013 edition (Thomson Reuters 2013) chapter 'Directors of Investment Companies'.

⁷⁴ H Knickle, 'The Mutual Fund's Section 15(c) Process: Jones V Harris, the SEC and the Fiduciary Duties of Directors' (2011-2012) 31 *Review of Banking & Financial Law* 265-340.

⁷⁵ Directive 85/611/EEC, article 8 and 15.

⁷⁶ Vandamme (n3).

⁷⁷ Vandamme (n3).

⁷⁸ Benjamin and others (n19).

All the conditions of the 1985 UCITS Directive which regulated the activity of a depositary have been retained in the recast 2009 UCITS IV Directive. However, as will be considered in a subsequent part of this thesis, the financial crisis and the Madoff scandal tested the European fragmented approach to the regulation of depositaries and, as a consequence, new initiatives were proposed directed towards a harmonised regulation of this field of financial services.

In the field of UCITS, the Commission issued the 2012 UCITS V Proposal which regulates the depositary role and sets detailed eligibility criteria and requirements on liability, delegation and its oversight function.⁷⁹ Apart from addressing the investor protection concerns that emerged from the financial crisis and the Madoff Scandal, harmonisation of regulation in this field could be a precursor for a proposal to grant depositaries access to the internal market. This point is examined in detail in chapter 5.

3.3 The failed UCITS II Initiative

The first European attempt to remove the barriers to cross-border marketing of collective investment schemes through the adoption of the 1985 UCITS Directive only managed to achieve a limited level of integration of the European funds industry.⁸⁰ This state of affairs may be explained on the basis of the limitations of mutual recognition identified in this chapter.

This chapter argues that the inconsistent interpretation and implementation of the 1985 UCITS Directive by the Member States, coupled with the regulatory burden of a passporting notification procedure which allowed discretion to the host Member State in the form of national marketing rules, proved to be a substantial limitation to the governance mechanism for mutual recognition in the field of UCITS. The 1985 UCITS Directive also did not afford the UCITS management company and the depositary with a passport to provide cross-border services, thereby creating a regulatory limitation to mutual recognition in the field of UCITS. Lastly, the chapter also contends that the tight

⁷⁹ Commission, 'Proposal for a Directive amending Directive 2009/65/EC as regards depositary functions, remuneration policies and sanctions' COM(2012)350<<http://goo.gl/bvWJxi>>accessed 16.03.14.

⁸⁰ Moloney (*n1*) 265.

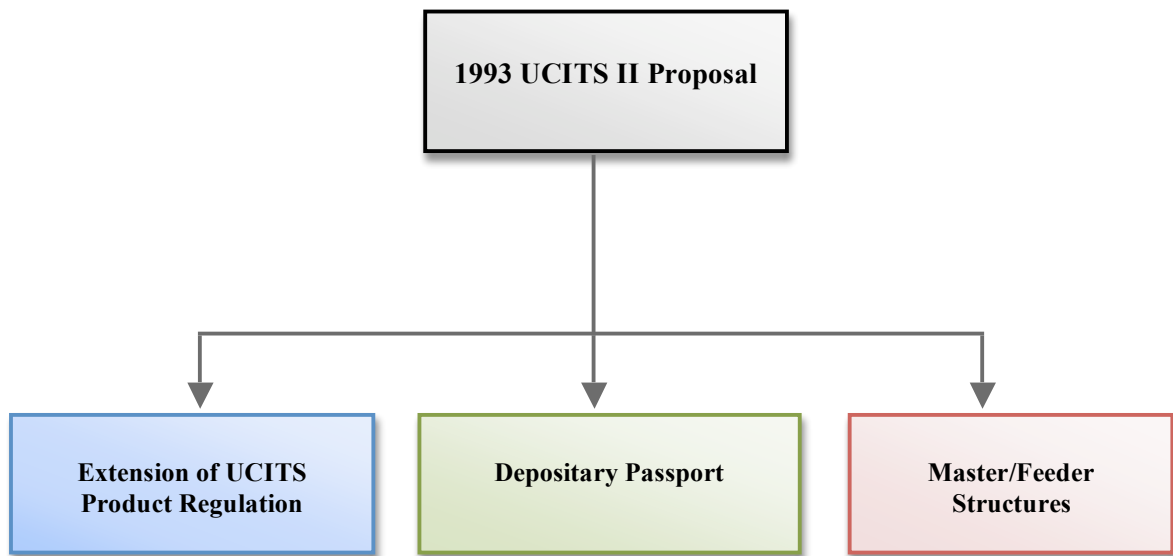
requirement on the eligibility of assets for investment by a UCITS, that applied in terms of the 1985 UCITS Directive, prevented a wider variety of collective investment schemes from having access to the internal market and prevented UCITS from participating in the development of financial markets. This was another regulatory limitation to mutual recognition in this field.

While the 1985 UCITS Directive was a first critical step towards the integration of the European fund industry, its contribution in this regard was limited, albeit significant for the triggering of a process of integration in this field. The limitations of mutual recognition identified so far were not easily resolved.

A first major attempt to reform the 1985 UCITS Directive was made by the Commission in February 1993 with the issue of a proposal⁸¹, having the aim of addressing some of the identified weaknesses of the Directive. The 1993 UCITS Proposal, suggested the extension of the scope of the UCITS Directive to include money market funds and funds of funds. It also proposed the introduction of a depositary passport and the application of master-feeder structures.⁸² If adopted by Council, the proposal would have overcome some of the limitations of the regulatory framework for mutual recognition identified in an earlier section of this chapter.

⁸¹ Commission, 'Proposal amending Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions Relating to UCITS', Com(93)37, 09.02.93<<http://goo.gl/rRSdJO>>accessed 15.03.14.

⁸² D Ciani, 'European Investment Funds: The UCITS Directive of 1985 and the Objectives of the Proposal for a UCITS II Directive' (1996) 4(2) Journal of Financial Regulation and Compliance 150-156.

Diagram 3.4 - 1993 UCITS II Proposal

The introduction of money market funds and funds of UCITS was a means of achieving a higher degree of integration of European financial markets as this would have removed the restrictions on the free circulation of the units of these funds. At the time, these type of funds were considered as having operational features and investment objectives which may be regarded as very close to UCITS as conceived in terms of the 1985 UCITS Directive and therefore adequate as an investment for retail investors.

The 1993 UCITS Proposal also recommended the creation of an internal market for depositaries of UCITS, thereby overcoming the regulatory limitation to mutual recognition with regard to this type of service provider. Further to the introduction of the Second Banking Directive⁸³ and the Investment Services Directive⁸⁴ which created an internal market for credit institutions and investment firms, it was felt that the necessary conditions had been established to allow UCITS the freedom to choose a depositary established in another Member State which had been authorised in terms of these Directives to provide safekeeping and administration services. On this very important proposed development for the internal market in financial services the proposal explained:

⁸³ Directive 89/646/EEC.

⁸⁴ Directive 93/22/EEC.

When the Directive was adopted in 1985 the principles of the EC-passport for credit institutions and investment firms and of home country supervision had not been laid down, and it was therefore natural to require establishment. However, after the adoption of the Second Banking Coordination Directive and the Investment Services Directive, the logical consequences should be that the establishment requirements for EEC-coordinated depositaries should be deleted.⁸⁵

In terms of the 1985 UCITS Directive, credit institutions and investment firms which provided depositary services were specifically not allowed to take advantage of the freedoms to provide services and establishment stipulated in the EC Treaty, the Second Banking Directive and the Investment Services Directive. The UCITS Directive was thus creating a limitation to mutual recognition in this field. Those Member States where the depositary industry was not developed were as a result put at a disadvantage. Given the lack of competition from external depositaries this would give rise to inefficiencies within the local depositary business which would generate extra costs for the UCITS established in these Member States. Such costs would in the end be borne by the investor.

One may argue that the creation of a depositary passport was necessary in order to generate competition, which would also guarantee an adequate level of efficiency within the depositary industry. The passport would have broadened the choice of depositaries available to UCITS, which would have been able to pick the best offer suited to their needs and would have benefited from a higher degree of competition which generally results in a reduction of fees to the UCITS and overall costs to the investor.

As further examined in chapter 5 of the thesis, the need for a depositary passport to generate and benefit from competition is even more relevant today following the coming into force of the AIFMD⁸⁶. The AIFMD requirements on depositaries, which are also in the process of being applied to UCITS⁸⁷, while still requiring the depositary to be established in the same Member State of the fund, introduce more robust investor

⁸⁵ Commission (n81).

⁸⁶ Directive 2011/61/EU.

⁸⁷ On the 25.02.14 the Greek Presidency reached political agreement with the European Parliament on UCITS V <<http://goo.gl/PH14wW>> accessed 28.02.14.

protection regulation of the functions, duties and liability of such entities.⁸⁸ The new rules on liability require restitution in instances where a financial instrument is lost unless this is caused by *force majeure*.⁸⁹ The liability will also extend to losses at the level of the sub-custodian which means that even failures of unaffiliated depositaries will be considered as internal to the depositary.⁹⁰

The implementation of the proposed strict liability requirements, together with the significant onus put on depositaries with regard to their duties, will most certainly result in considerable costs for the depositary industry.⁹¹ These costs will lead to consolidation within the industry. In order to remain a viable business activity and to benefit from economies of scale, it is expected that small-medium sized depositaries will have to come together or cease to provide depositary services altogether. As a consequence of possible consolidation, one may reasonably predict that only a few depositaries will remain active in Europe, these being the global custodian banks, which however are not present in all Member States. This outcome could lead to monopolistic behaviour and consequently an increase in the direct expense of engaging a depositary. Consolidation may result in an unfair level playing field for those UCITS established in Member States with an undeveloped depositary industry.⁹² Therefore, the creation of a depositary passport remains necessary today to address the competition issues that result from existing regulation.

At the time of the 1993 UCITS Proposal, the authorisation procedure for credit institutions and investment firms together with the harmonisation of the on-going regulatory requirements, which had to be satisfied by these entities respectively in terms of the Second Banking Directive and Investment Services Directive, had created a number of safeguards to guarantee and to ensure an adequate level of protection for investors. Thus, there seemed to be no economic, regulatory or supervisory rationale to impede the application of the mutual recognition principle in the field of depositary and to operate an EEA passport for depositaries.

⁸⁸ Commission (n79).

⁸⁹ C Buttigieg, 'An Examination of Policy Trends in EU Financial Regulation applicable to Investment Funds' (2013) *The Accountant* 14-20.

⁹⁰ Buttigieg (n89).

⁹¹ Ernst & Young, 'AIFMD: Get Ready for Depositary Reform' (2012) <www.ey.com> accessed 24.12.13.

⁹² Buttigieg (n89).

Within seventeen months the Commission issued an amended proposal. Indeed, further to discussions with the industry, and following the issue of a formal opinion on the 1993 UCITS Proposal by the Economic and Social Committee and the publication of a number of amendments to the proposal approved by the European Parliament on the 27th October 1993, the Commission issued an updated proposal on the 20th July 1994⁹³. The 1994 UCITS Proposal would have added to the flexibility of the UCITS regime and therefore would have made it more suitable and better equipped to participate in the development of financial markets. The proposal was also amended in order to apply the new governance mechanism for the EU financial regulation, which had changed with the coming into force of the Treaty of Maastricht in November 1993. The Treaty had changed the mechanics for the adoption of changes to the UCITS Directive, as the Council could now approve the amendments on the basis of qualified majority voting, while the European Parliament was granted a right of co-decision with the Council in this field.

The 1994 UCITS Proposal widened the scope of the Directive by extending UCITS not only to money market funds and funds of UCITS, as had been proposed in the 1993 UCITS Proposal, but also to cash funds and master-feeder structures.⁹⁴ The latter is a collective investment scheme structure wherein capital that is raised from different categories or groups of investors (such as investors coming from different jurisdictions) and which is invested in different feeder funds established for each group, is pooled into one collective investment scheme referred to as the master fund. Investors invest in the feeder funds, which in turn invest their liquidity into the master fund. The master fund is responsible for making all the portfolio investments and also carries out the trading activity. The origins of master-feeder structures lie in the US where managers have implemented such structures in order to attain tax efficiency, enhance the critical mass of tradable assets and enhance operational efficiency thereby reducing costs.

⁹³ Commission, 'Amended proposal for a Directive amending Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions Relating to UCITS', Com(94)329, 20.07.94 <<http://goo.gl/cMcOCa>> accessed 15.03.14.

⁹⁴ Clifford Chance, 'Single Market Update Services' (1995) 8 Journal of International Banking and Financial Law 412.

A major advantage of this structure is that it allows the merging of multiple portfolios of liquidity into one. This would reduce the average administrative costs (such as trading and operational costs) suffered by the collective investment scheme and the ultimate investors. In virtue of the size of the master fund, the master-feeder structure also benefits from economies of scale and would therefore be able to obtain better service and more favourable terms from its service providers, such as managers, depositories and auditors. Master-feeder structures are an excellent means of promoting cross-border financial flows, which is fundamental for the integration of EU financial markets.

The updates to the UCITS Directive as detailed in the 1994 UCITS Proposal were considered to be too far reaching by Member States. The discussions on the draft in the Council revealed considerable divergences in the approach of Member States on various aspects of the 1994 UCITS Proposal.⁹⁵ The main points of contention in the Council were the extension of the scope of the UCITS Directive to master-feeder structures and the proposals relating to depositories.⁹⁶ With regards to the latter, there was significant disagreement even at the level of the European Parliament.

In view of the extended role granted to the European Parliament in the governance of European financial regulation, after the coming into force of the Maastricht Treaty, it is worthwhile analysing the regulatory activism of this European Institution by examining the issues raised by the Rapporteur of the European Committee on Legal and Citizens' Rights of the European Parliament on the 1994 UCITS Proposal.

MEP Perreau De Pinninck suggested two fundamental reasons why depositories should not be granted a passport in terms of the Directive.⁹⁷ He argued that the Commission's proposal to grant credit institutions and investment firms the possibility to passport depositary services on the basis that they were already authorised to provide safekeeping of assets and administrative services in terms of the Second Banking Directive and the Investment Services Directive as confusing the function of mere

⁹⁵ International Law Review, 'UCITS provisions' (1995) 54.

⁹⁶ Clifford Chance, 'Single Market Update Services' (1996) 9 Journal of International Banking and Financial Law 457.

⁹⁷ European Parliament, 'Report of the Committee on Legal Affairs and Citizen's Rights on the 1993 UCITS Proposal', (A5-0268/1993)01.10.93<<http://goo.gl/rRSdJO>>accessed 15.03.14.

safekeeping of assets with the complex role that a depositary must fulfil in relation to collective investment schemes. MEP Perreau De Pinninck specifically remarked:

The depositary of a UCITS does not restrict itself to correct safekeeping of deposited assets (collection of dividends or interest, presenting securities for redemption, acting in cases of capital increases or new issues, etc.); it also does the work of high added value, such as supervising the management company and its investment policies, calculating the cash value of the fund, etc ... Thus, the functions of a depositary of an UCITS are not those described in the directives and it is extremely simplistic to describe these tasks as being no more than safekeeping and administration of securities.⁹⁸

Moreover, he felt that allowing a depositary passport would create a number of legal issues, such as which legal system should apply in case of default where the depositary may be found negligent and therefore liable to the Scheme, as well as technical complications, in the form of a lesser level of coordination and cooperation between the management company and the depositary, which would in the end result in lesser protection afforded to the retail investor. On the basis of these two fundamental points, he recommended that the depositary of a UCITS should not be given an internal market passport and should continue to be established in the same Member State as the UCITS.

The position taken by MEP Perreau De Pinninck suggests a possible concern shared by policy-makers within the European Parliament that mutual recognition with regard to depositaries would not be possible. There existed a lack of sufficient harmonisation with regard to the requirements which dictate the duties that should be carried out by a depositary for this service provider to properly fulfil its monitoring and safekeeping role in the best interest of the UCITS and the retail investors. In addition, the EU proposal had not provided for the harmonisation of the criteria which an entity must satisfy before it may be eligible and permitted to act as a depositary of a UCITS.

Neither did the proposal provide for a robust harmonised prudential and conduct of business regulatory framework focusing on depositary duties, which in field of financial

⁹⁸ European Parliament (n97).

regulation is considered as yet another fundamental variable for the proper functioning of mutual recognition between financial supervisors and consequently the proper application of an internal market passport.

Moreover, basing oneself on the remarks by MEP Perreau De Pinninck regarding possible legal issues that could arise as a consequence of the liability of depositaries to the Scheme where the depositary is found to have acted negligently, it is logical to conclude that mutual recognition in this field and the application of an internal market passport would have also required a certain degree of harmonisation with regard to civil liability. Specifically in establishing whether a depositary should be subject to an obligation of means or an obligation of result with regards to the performance of its duties, where significant differences existed between Member States. These were considerably ambitious steps for policy-makers at this early stage of the integration of EU financial services.

In the end, policy-makers considered that the 1994 UCITS Proposal did not contain enough harmonisation of substantive requirements of investor protection type to allow mutual recognition with regards to depositary business to operate properly.

The failure of Member States to reach an agreement with the European Parliament on the 1994 UCITS Proposal put negotiations into a deadlock. As a consequence, during its meeting held in March 1995, the Council asked the Commission to carry out a more thorough examination of the technical dimension and the issues surrounding its proposal and to make a new proposal.⁹⁹ During the initial stages of the EU's development of the internal market for UCITS, the Council and the European Parliament were still rather hesitant to give way to far reaching initiatives for the further opening up of the EU's funds industry. This is indicative of a policy which may have been inclined to protect national industries, the characteristics of which still varied significantly from one another, and that Member States were not yet prepared to widen mutual recognition in this field.

⁹⁹ Benjamin and others (*n19*).

In the final analysis, it may be argued that Member States' inclination to protect national industries created a barrier to the development of EU law for wider mutual recognition and deeper integration of the internal market for UCITS. As a result it is not surprising that the evolution of an internal market for the retail funds industry through the UCITS Directive has been and is still characterised by the taking of several prudent small steps at a time. In fact, by reference to the causes of the failure of the UCITS II Proposal, in the end Member States managed to find a compromise with regard to the introduction of master-feeder UCITS, which was eventually crystallised in the 2009 UCITS IV Directive, more than sixteen years after the 1993 UCITS Proposal. On the other hand, the creation of an internal market for depositary business is still an area where, notwithstanding various proposals, the EU institutions still need to come to a final agreement.

3.4 The UCITS III Directive – Overcoming the Limitations of the Regulatory Framework for Mutual Recognition

As a consequence of the European Parliament's objections and the differences in Council on the 1994 UCITS II proposal, the limitations of the regulatory framework for mutual recognition established by the 1985 UCITS Directive persisted. UCITS continued being an investment vehicle with restricted investment openings, as the investment restrictions set in the 1985 UCITS Directive, which afforded a very limited definition of permitted investments, had remained unchanged. Since the adoption of 1985 UCITS Directive, financial markets had continued to evolve at a fast rate rendering the investment restrictions in the Directive inadequate for the further development of the internal market for the European funds industry. Moreover, the 1985 UCITS Directive remained a product directive, which prohibited the management company and the depositary from providing cross-border services.

The Commission's policy establishing that collective investment schemes ought to be widely available as saving vehicles for retail investors and for the channelling of such savings to European financial markets remained a priority. The adoption of the single currency in 1999 added a sense of urgency to the need of updating financial services legislation to further widen the integration of European financial markets. This given that the full benefits of the single currency would not have been achievable unless a

fully integrated internal market for financial services was in place.¹⁰⁰ The position of the Commission on the benefits that could be derived from a broader internal market for collective investment schemes was also supported by empirical research carried out during this period. Using firm-level data of 11 European countries covering a period from 1994 to 2003, it was demonstrated that a 5% reduction in barriers to cross-border activity would result in a 2% increase in productivity due to a more competitive environment.¹⁰¹

In the field of collective investment schemes in particular, empirical research suggested that a properly integrated internal market in this field would generate three key benefits: [i] an increase in the choice of financial products available to retail investor; [ii] the realisation of economies of scale within the funds industry; and [iii] the intensification of competition for the benefit of investors.¹⁰² The internal market objective therefore remained at the heart of the reform of EU financial regulation which was being proposed by the Commission during this period.

The Commission published a fresh legislative initiative in July 1998 which had the purpose of seeking to surmount part of the limitations of the regulatory framework for mutual recognition. The Commission's initiative eventually led to the adoption by the Council and the European Parliament in 2001, of two directives that addressed part of the limitations of mutual recognition in the field of UCITS. It is noteworthy that while the governance mechanism for mutual recognition continued to be based on minimum harmonisation, home country control and complementary host country supervision, the mechanism for making the proposal was adapted to take into account the lesson learnt from the failed UCITS II proposal.

¹⁰⁰ M Monti, 'Commission proposes to improve and extend rules on collective investment undertakings', PressRelease IP/98/673, 17.07.98<<http://goo.gl/o1XsMq>>accessed 15.03.14.

¹⁰¹ M DelGatto, G Mion, and G Ottaviano, 'Trade integration, firm selection and the costs of Non-Europe' (2006) CEPR Paper No.5730<<http://goo.gl/npL4Ws>>accessed 15.03.14.

¹⁰² F Heinemann, 'The Benefits of creating an integrated EU Market for Investment Funds' (2000) Centre for European Economic Research Paper No.02-27<www.ssrn.com>accessed 27.01.11.

3.4.1 An Evolving Governance Mechanism to Achieve Mutual Recognition

The Commission's 1998 initiative to amend the 1985 UCITS Directive was divided into two, a proposal to include other types of collective investment schemes within the meaning of UCITS by widening the array of assets in which a UCITS may invest¹⁰³ ('the 1998 UCITS Product Proposal') and a proposal to regulate management companies and provide them with access to the internal market and to establish a uniform simplified prospectus¹⁰⁴ ('the 1998 UCITS Management Company and Prospectus Proposal').

Acting on the experience with the failed UCITS II proposal, the Commission's adjusted the legislative procedure for making a proposal by issuing two legislative initiatives instead of a single and all encompassing proposal. The change in the governance mechanism was implemented in order to avoid that a disagreement on one of the elements being proposed would result in delays to the other aspects of the Directive with respect to which a compromise could be reached. In fact, the new rules proposed in the 1998 UCITS Management Company and Prospectus Proposal were deemed as more complex and controversial than those of the 1998 UCITS Product Proposal.¹⁰⁵ The Commission explained the choice of method as follows:

The separation of topics involving different problems could facilitate the negotiating process in the Council. It will not matter if one of the two Directives is adopted more rapidly than the other one.¹⁰⁶

This change in the mechanism adopted by the Commission for proposing different sets of amendments to a Directive in the field of financial services, raised concerns at the

¹⁰³ Commission, 'Proposal for a Directive amending Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions Relating to UCITS', Com(1998)449, 17.07.98 <<http://goo.gl/cRUyMP>>accessed 15.03.14.

¹⁰⁴ Commission, 'Proposal for a Directive amending Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions Relating to UCITS with a view to regulating the management company and simplified prospectus', Com(1998)451, 17.07.98 <<http://goo.gl/tnV5Iz>>accessed 15.03.14.

¹⁰⁵ T Paul, 'UCITS III: An analysis of the Proposals for the amendment of the European Investment Fund Directive' (2001) 16(4) Journal of International Banking Law 105-111.

¹⁰⁶ Commission (n103) 3.

level of the European Parliament¹⁰⁷ and the ECB¹⁰⁸ both of which argued in favour of having the two proposals being considered together and implemented simultaneously. The European Parliament's position was based on the premise that the two proposals were complementary as the 1998 Product Proposal aimed at widening the investment opportunities for UCITS whilst the 1998 Management Company and Prospectus Proposal contained a number of new provisions which strengthened investor protection by *inter alia* enhancing the requirements on transparency with investors.

The ECB raised similar concerns. For the ECB the Commission's approach could possibly have an impact on the clarity, transparency and legal certainty of the outcome of these proposals as these were complementary and could not be separated. It, however, also raised more fundamental regulatory issues on the governance mechanism for mutual recognition in the field of UCITS. In its report the ECB stated the following:

... the UCITS Directive appears to have been interpreted differently by Member States. Such different interpretations are undesirable in the context of a single money and financial market and may lead to competitive distortions and misallocation of funds.¹⁰⁹

The ECB was concerned that the limitations of the governance mechanism for mutual recognition based on minimum harmonisation of regulation, which resulted in different interpretations of the Directive by Member States and a distorted application of its requirements, were potentially preventing a genuine level playing field among financial services operators in this field and were therefore hindering effective investor protection. As a consequence, a fragmented approach to the implementation of the different proposed changes to the Directive would have possibly exacerbated what already was a widely uneven application of the Directive in general.

The ECB's remarks also suggest a concern about the possible threats to the stability and integrity of the internal market of a non-harmonised approach to the application of the regulation applicable in the field of financial services. Given the introduction of the

¹⁰⁷ European Parliament Report on the 1998 UCITS Proposal, (A5-0025/2000) 01.02.00<<http://goo.gl/cRUyMP>>accessed 15.03.14.

¹⁰⁸ Opinion of the ECB, (CON/98/54), 16.03.99<<http://goo.gl/xWu1bJ>>accessed 15.04.14

¹⁰⁹ ECB (n108).

euro there existed a higher possibility of contagion from fragmented regulation and supervision.¹¹⁰ The euro coupled with more integrated financial markets would have raised the risk of cross-border contagion since events in one Member State would now have had a substantial impact on financial markets elsewhere.

The interconnectedness of financial markets made financial stability a matter of higher concern which in turn justified a move towards more comprehensive harmonisation with the need of a lower degree of mutual recognition, as it might be difficult to achieve simultaneously an integrated financial market and stability in the financial system, while preserving a high degree of nationally based regulation and with only decentralised efforts at harmonisation.¹¹¹ Therefore, it is reasonable to argue that for the ECB the push for reform of financial regulation was an opportunity to update the existing framework, which was inadequate to address financial stability concerns that could arise from cross-border contagion.

The ECB's remarks also highlighted the regulatory and supervisory concerns regarding the potential negative impact on the financial system that could arise as a result of the failure of a collective investment scheme. This concern arose after the collapse of LTCM, a trillion dollar fund in the US.¹¹² At the time when the UCITS III proposals were being considered, US financial institutions were forced to bail out LTCM, as it was largely feared that given its extensive counterparty exposures, its failure could cause a chain reaction in various financial markets, thus creating catastrophic losses throughout the international financial system.¹¹³

While the traditional rationale for the financial regulation of collective investment schemes was that of addressing investor protection concerns, the LTCM incident proved beyond doubt the direct correlation between the activity of collective investment

¹¹⁰ R Lastra, 'The Governance Structure of Financial Regulation and Supervision in Europe' (2003) 10 *Columbia Journal of European Law* 49-68. See also D Schoenmaker and S Oosterloo, 'Cross-border issues in European Financial Supervision' in D Mayes and G Wood *The Structure of Financial Supervision* (Routledge 2007) 264-304.

¹¹¹ N Thygesen, 'Comments on The Political Economy of Financial Harmonisation in Europe', in J Kremers, D Schoenmaker and P Wierds, *Financial Supervision in Europe*, (Elgar, 2003).

¹¹² ECB, 'Large EU Bank's Exposures to Hedge Funds' November 2005 <<http://goo.gl/imNWSJ>> accessed 31.12.12.

¹¹³ R Lowenstein, *When Genius Failed: The Rise of Long-Term Capital Management* (Harper Collins 2001).

schemes, monetary policy and the economy at large.¹¹⁴ It established that the activity of a collective investment scheme could result in the spreading of financial contagion from one market to another and potentially pose significant risks to other regulated institutions, financial markets and the financial system as a whole.¹¹⁵ It is therefore not surprising that in the wake of this background, policy-makers' attention, including that of the ECB, started to focus on the systemic nature of collective investment schemes.¹¹⁶ Uniform systemic risk type regulation, which seeks to ensure the stability of collective investment schemes had become part of the formula for a regulatory framework for mutual recognition.

The concerns about the limitations of the governance mechanism for mutual recognition, however, remained. Indeed, at this stage it became clear to policy-makers that minimum harmonisation, which allowed various derogations and national discretions, the lack of uniform implementation and application of the Directive, and the inexistence of any degree of supervisory convergence could weaken the control of the home financial supervisor and lead to obstructive host financial supervisor activism.¹¹⁷ These were the catalyst for the eventual adoption of a new governance mechanism for mutual recognition that is known as the Lamfalussy Process and which *inter alia* required a higher degree of harmonisation of regulation and the establishment of three European regulatory committees, such as CESR, which had the high-level objective of seeking to achieve coordinated practical implementation of European legislation and supervisory convergence.

¹¹⁴ J Thieffry, 'Towards a European Securities Commission' (1999) 1(7) *Journal of International Financial Markets* 302. Also see Commission, 'Impact Assessment: Proposal for a Directive on Alternative Investment Fund Managers, SEC(2009)576, 20.04.09 64<<http://goo.gl/zTt1ej>>accessed 15.03.14.

¹¹⁵ D Rouch and G Morton, 'Learning from LTCM' (1999) 1(3) *Journal of International Financial Markets* 93; R Bollen, 'Setting international regulatory standards for hedge funds: Part 1' (2011) 26(2) *Journal of International Banking Law and Regulation* 67.

¹¹⁶ P Yeoh, 'Hedge Funds: From privileged child to locust and now bogeyman?' (2012) 33(2) *Company Lawyer* 42.

¹¹⁷ N Moloney, 'New Frontiers in EC Capital Markets Law: From Market Construction to Market Regulation' (2003) 40 *Common Market Law Review* 810.

3.4.2 The 2001 UCITS Product Directive

The 1998 UCITS Proposals were issued at a time when the introduction of the euro had created the impetus for further development of the internal market project for financial services.¹¹⁸ In recognition of the changing financial landscape and the importance of well functioning financial markets, the Cardiff Council, in June 1998, invited the Commission to present an action plan to improve the internal market for financial services in general. The EU's policy-makers planned to move a step ahead in the construction of the internal market by building a legislative framework, which would allow the development of an integrated European financial market focused on the eurozone.¹¹⁹

The Commission presented the action plan for financial services in 1999, which was welcomed by the Lisbon Council in 2000, as part of the overall Lisbon Agenda of making Europe the world's most competitive economy. The FSAP was a blueprint for the creation of an internal market in financial services through the implementation of forty two legislative proposals intended to further the integration of EU financial markets. During this period, it was generally accepted that the internal market for the provision of retail financial services was incomplete.¹²⁰ One of the strategic objectives of the FSAP was that of creating an internal market that works for retail investors and which would allow them to save effectively for their retirement.¹²¹ On this point it is interesting to note the clear position of EU policy-makers:

Demographic trends require a secure and productive complement to statutory pension schemes.¹²² ... This industry plays a vital macroeconomic role in Europe's economy. It contributes to fostering financial independence during working life-time and to sustaining a high quality of life also during retirement

¹¹⁸ Commission, 'Implementing the Framework for Financial Markets: Action Plan', COM(1999)232 <<http://goo.gl/3D18dO>>accessed 15.03.14.

¹¹⁹ M McKee, 'The proposed EU Market Abuse Directive' (2001) 3(4) Journal of International Financial Markets 137.

¹²⁰ A Lamfalussy, 'Towards an Integrated European Financial Market' (2001) The World Economy 1287-1294.

¹²¹ J Coffey and J Overett Somnier, 'The Market Abuse Directive – the first use of the Lamfalussy process' (2003) 18(9) Journal of International Banking Law and Regulation.

¹²² Commission, 'Communication to the European Parliament and the Council: Upgrading the Investment Services Directive (92/33/EEC)' COM(2000)729 15.11.00<<http://goo.gl/Io9tHZ>>accessed 15.04.14.

for the European citizens.¹²³ ... Integrated European markets with more flexible investment rules, therefore, should improve the risk-return frontier. Higher returns could also lower the cost of ... schemes, resulting in ... an improvement in competitiveness. ... steps to relax regulatory constraints on the investment strategies of ... schemes should sustain a greater presence by European funds in equity and investment funds business.¹²⁴

The above statements suggest a continuation of the EU's policy to create a regulatory environment, which would sustain the investment fund's industry fundamental role in supporting savings for retirement. It also suggests that the creation of a regulatory framework, which would allow the formation of a broader and more efficient internal market for investment funds, formed an integral part of the high-level objectives of the EU's reform of the regulation of financial services. It is reasonable to argue that the achievement of these retail investor policy objectives would have required a political agreement on the changes to the UCITS Directive, which would have broadened the regulatory framework for mutual recognition in this field.

With the aim of achieving a broader internal market for collective investment schemes, the 1998 UCITS III Product Proposal recommended the removal of the barriers to cross-border marketing of a wider array of collective investment schemes. It proposed the extension of the list of collective investment schemes that qualify as UCITS, to funds of funds; money market funds; cash funds; and funds that invest in standardised options and future contracts.¹²⁵ It follows that an agreement on the extension of the scope of the UCITS Directive to additional types of collective investment schemes mentioned above would have addressed one of the identified limitations of the regulatory framework for mutual recognition in terms of the 1985 UCITS Directive, as now UCITS would have been subject to a more flexible regime regarding eligible assets.

Nevertheless, maintaining investor protection standards while allowing additional types of collective investment schemes within scope of the 1985 UCITS Directive would have

¹²³ Asset Management Expert Group, 'FSAP: Progress and Prospects – Final Report' May 2004. <<http://goo.gl/xeEFfi>>accessed 15.03.14.

¹²⁴ Committee of Wise Men (Lamfalussy Group), 'Initial Report', Brussels 09.11.00 <<http://goo.gl/qHT2FV>>accessed 15.03.14.

¹²⁵ J Stuyft, 'UCITS III: more Europe in the investment fund industry' (2002) 103 EU Focus.

required the adoption of additional substantive requirements, to mitigate the possible risks to retail investor protection, which could materialise from these additional specific types of schemes. For this purpose, the 1998 UCITS III Product Proposal proposed the adoption of enhanced transparency standards. It also proposed minimum control standards for the use of derivatives, the application of which was being extended from merely being allowed for the purpose of efficient portfolio management and hedging to being allowed also as an investment, which can form part of the investment policy of UCITS.¹²⁶

The 1998 UCITS III Product Proposal was therefore a new attempt by the Commission to resolve issues, which had been dealt with, in part, in the 1994 UCITS II proposal. Indeed, it may be argued that the recommended extension of the meaning of UCITS was the Commission's solution to address the failure of 1985 UCITS Directive to create a broad internal market for collective investment schemes.¹²⁷ As explained by the Commission, the extension of permissible assets would:

... favour the development of cross-border activity and prompt beneficial effects since it will offer more opportunities to the European collective investment undertakings industry and a wider choice of investments to investors. The broadening of the scope of the UCITS Directive therefore represents a necessary step to create a fully integrated Single Market in the area of collective investment undertakings.¹²⁸

The discussions within the Council and the European Parliament on the 1998 Product Proposal and the opinion issued by the ECB and the European Economic and Social Committee, led to various recommendations being made for the clarification of certain aspects of the proposal and the extension of the list of assets that may form part of the portfolio of a UCITS. In particular, a general view was expressed that the participation of UCITS in derivative transactions for investment purposes should not be limited to standardised derivatives, which are traded on a regulated market, but should be extended to OTC derivatives. The European Parliament was of the view that given that

¹²⁶ Paul (*n105*).

¹²⁷ Committee of Wise Men (*n124*) 34.

¹²⁸ Commission (*n103*) 5.

the market for OTC derivatives in Member States had grown very rapidly, it was important that regulation of eligible assets is flexible so that UCITS are not restrained from participating in these developments.¹²⁹

The Commission amended its 1998 Product Proposal¹³⁰ mainly to extend the investment opportunities for UCITS to OTC derivatives. This change, which was largely welcomed by EU policy-makers, was eventually adopted by the Council and the European Parliament in the 2001 UCITS Product Directive.¹³¹ It may be argued that this was one of the catalysts for the development of UCITS from a simple and linear unsophisticated retail product to an instrument used by the industry to package complex type funds, such as hedge funds, into UCITS which can be marketed across the EU to retail investors.¹³² This, together with the adoption of all the other recommended significant changes incorporated in the 2001 UCITS Product Directive had finally, after sixteen long years of negotiations, amended the 1985 UCITS Directive in a way which made it possible for a UCITS to invest in instruments other than transferable securities and, by so doing, addressed one of the three regulatory limitations to mutual recognition in this field.

The changes adopted through the 2001 UCITS Product Directive, especially the introduction of the requirements that UCITS could participate in derivative financial instruments for investment purposes, had completely changed the dynamics of UCITS. This raised several financial stability and investor protection concerns, as without proper regulation and supervision, the widening of the scope of what could constitute a UCITS would have significantly increased the risk profile of this retail investor product. This particularly in the light of the events surrounding the failure of LTCM. Indeed, the active participation of LTCM in the unregulated OTC Derivative market, which allowed this fund to build up an extensive leveraged position, had played a dominant role in its dramatic failure.¹³³ The LTCM failure was attributed to a non-existent regulatory

¹²⁹ European Parliament (*n107*) 30.

¹³⁰ Commission, 'Amended proposal for a Directive amending Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions Relating to UCITS', Com(2000)329, 30.05.00<<http://goo.gl/wgR1Xx>>accessed 15.04.14

¹³¹ Directive 2001/108/EC.

¹³² N Amenc and S Sender, 'Are Hedge-Fund UCITS the Cure-All?' (2010) EDHEC Institute Publication<<http://goo.gl/L7x3PF>>accessed 15.03.14.

¹³³ R Levine, 'The Governance of Financial Regulation: Reform Lessons From the Recent Crisis' (2010) BIS Paper 329<www.bis.org/publ/work329.pdf>accessed 16.03.14.

framework applicable to such funds, ineffective risk management processes and inadequate disclosure on its business activity to its counterparties and to the market.¹³⁴ It is reasonable to suggest that these identified failures had an influence on the direction of the legislative process. Indeed, it is noteworthy that each of these identified failures were in fact addressed in the 2001 UCITS Product Directive. Albeit, the financial crisis suggests that these measures were not enough to mitigate completely the possibility of systemic risk.

Against the backdrop of the LTCM debacle, it was clear that without a certain degree of uniformity of substantive requirements applicable to investments in derivatives, mutual recognition in this field would not have operated effectively. Indeed, while on the one hand the European Parliament insisted that UCITS should be allowed to participate in an OTC derivative contract for investment purposes, on the other it also emphasised the importance that such investment:

... should only be allowed on condition that both quantitative (risk exposure to a certain counter-party and total risk exposure) and qualitative criteria are introduced to guarantee the protection of investors ...¹³⁵

This point was also supported by the Council, which together with the European Parliament and the Commission devised substantive requirements applicable to UCITS, which invest in derivatives.¹³⁶ The amended 1985 UCITS Directive required the application of a risk-management process, which was to be implemented by a UCITS or its management company to monitor and measure, at any time, the risk of positions, particularly derivatives and their contribution to the overall risk profile of the UCITS' portfolio. The methodology for measuring the relevant risk in this regard was laid down in a Commission Recommendation, issued in 2004, which *inter alia* had the purpose of

¹³⁴ Financial Stability Forum, 'Report of the Working Party on Highly Leveraged Institutions' 5 April 2000 <www.financialstabilityboard.org> accessed 08.03.12; I Levine and M Chambers, 'Legal Risk Management and Transacting Business with Hedge Funds: Is there a brave new World?' (2005) 10 Journal of International Banking and Financial Law 413; G Rodriguez Paez, 'LTCM and other major hedge fund failures: Part 2' (2009) 24(6) Journal of International Banking Law and Regulation 304–306.

¹³⁵ European Parliament (n107) 30.

¹³⁶ European Parliament Report on the 1998/2000 UCITS Proposal, (A5-0324/2001) 10.10.01, 10 <<http://goo.gl/cRUyMP>> accessed 15.03.14.

recommending a uniform understanding of risk methodologies for UCITS.¹³⁷ This is the first example of a soft-law mechanism being applied for the purpose of achieving regulatory convergence in the application of the Directive.

It may be argued that the implementation of a proper risk management process to allow a UCITS or its management company to properly identify, quantify and take remedial action to manage and mitigate risks, is a key factor for financial stability purposes and the protection of investors from the risks to which the UCITS may be exposed. It follows that the uniform regulation of risk management had become one of the fields, which would be critical for mutual recognition to operate effectively. Indeed, unless proper regulatory convergence of risk management requirements was achieved in this field, the European financial system and the retail investor could have become exposed to failures of faulty risk management processes and procedures that could emerge from inadequate implementation of regulation and the resulting development of regulatory arbitrage. The success of the rules on risk management to achieve proper investor protection and therefore contribute to the further integration of the internal market, *inter alia* depended on their uniform implementation and application by Member State financial supervisors.

In practice, unfortunately, the requirements on risk management were interpreted and applied inconsistently by Member States and their financial supervisors. This led to situations of possible lax supervision and as a consequence regulatory arbitrage and distrust between national financial supervisors.¹³⁸ This indeed was another situation that brought to bear the limitation of the governance mechanism for mutual recognition which existed at the time and which was based on minimum harmonisation of regulation. To address this situation and foster mutual confidence between national financial supervisors and promote a more robust governance structure for the monitoring of compliance of risk management requirements, CESR eventually issued a set of standards on risk management applicable to UCITS which indicated the manner in which the requirements of the Directive and the Commission Recommendation had to be applied in practice. This sought to ensure that, to a certain degree, all UCITS became

¹³⁷ Commission Recommendation of 27.04.04 on the use of financial derivative instruments for UCITS (2004/383/EC).

¹³⁸ CESR, 'Risk Management principles for UCITS', (CESR/09-178), February 2009 <<http://goo.gl/bvWyNY>>accessed 15.03.14.

subject to harmonised risk management processes, which provide a uniform level of investor protection.

With a view to ensure a higher degree of investor protection, the amended 1985 UCITS Directive set monitoring standards and reasonable limits to the investment by UCITS in derivative instruments. The amended Directive required the UCITS to ensure that its global exposure relating to derivatives does not exceed hundred percent of net assets¹³⁹ and set specific limits to the individual exposures to which a UCITS may be exposed when investing in a derivative.¹⁴⁰ As an additional safeguard, the amended 1985 UCITS Directive also required that the counterparty to an OTC derivative transaction had to be an institution which was subject to prudential regulation. Such counterparty also had to belong to a category of institutions which were recognised by the financial supervisor of the UCITS' home Member State. Furthermore, the OTC derivative had to be capable of being easily valued and liquidated at fair value on the initiative of the UCITS.¹⁴¹ Since OTC derivatives are generally illiquid and not easy to value, as these financial instruments are not traded on a regulated market, the latter requirement was paramount in order to ensure that a UCITS could continue to satisfy its primary obligation of being a liquid investment to the extent that it would be in a position to redeem the units belonging to an investor upon his/her request.

The Directive also required UCITS or its management company to report on a regular basis to the home financial supervisor of the UCITS, details about the derivative instruments which form part of the UCITS portfolio.¹⁴² In practice, regulatory standards would prove worthless in the absence of proper supervision and enforcement. On this basis, the Directive did not merely require the application of a degree of prudence with regard to investment in derivatives but also demanded a certain element of monitoring by financial supervisors. The foregoing requirement gave such supervisors the opportunity to monitor compliance by the UCITS with the limits set with regard to investment in derivatives. Practical experience in financial supervision suggests that monitoring a management company of a collective investment scheme to ascertain that it complies with the investment objectives, policies and restrictions set in the scheme's

¹³⁹ Directive 85/611/EEC (as amended by Directive 2001/107/EC and Directive 2001/108/EC), article 21.

¹⁴⁰ Directive 85/611/EEC (as amended by Directive 2001/107/EC and Directive 2001/108/EC), article 22.

¹⁴¹ Stuyft (*n125*).

¹⁴² Directive 85/611/EEC (as amended by Directive 2001/107/EC and Directive 2001/108/EC), article 21.

prospectus and in the case of UCITS, that it also complies with the requirements of the UCITS Directive, is generally one of the basic functions of any respectable and well functioning financial supervisor.¹⁴³

Given the importance of ensuring that a collective investment scheme does not fail in this respect, the depositary of the scheme is also normally vested with the role of monitoring compliance with applicable investment restrictions. Practical experience in financial supervision also suggests that while a financial supervisor would normally monitor compliance with the scheme's investment restrictions at regular intervals through off-site compliance supervision by reviewing the financial statements of the scheme and during on-site inspections at the offices of the management company and that of the scheme, a depositary would normally monitor compliance with the said investment restrictions on an on-going basis and report to the financial supervisor in case of identified failures.¹⁴⁴

With regard to the investment in derivatives by UCITS, in order to further enhance investor protection, EU policy-makers also applied the principle of *caveat emptor* by requiring UCITS to include additional disclosure in their prospectus about the types of strategies applied by the particular UCITS and the consequential risks that might arise as a result of their application.¹⁴⁵ As emphasised in different parts of the thesis, transparency is a fundamental investor protection and empowerment tool applied in the field of securities regulation.

While the changes brought about by the 2001 UCITS Product Directive, were necessary in order to extend the scope of investments for UCITS funds and to allow this product to develop, they generated uncertainty regarding the intended scope of these wider investment powers.¹⁴⁶ This became evident during implementation stage as Member States applied different interpretations to the new provisions laid down in the 2001

¹⁴³ The author is Deputy Director within the Securities and Markets Supervision Unit of the Malta Financial Services Authority and has several years of direct professional experience in policy, regulatory and supervisory matters in the field of securities regulation, including collective investment schemes, management companies and depositaries.

¹⁴⁴ (n143).

¹⁴⁵ Directive 85/611/EEC (as amended by Directive 201/107/EC and Directive 201/108/EC), article 24a.

¹⁴⁶ G Busdy, 'Implementation of the UCITS Eligible Assets Directive in the UK' (2008) 23(11) Journal of International Banking Law and Regulation 568.

UCITS Product Directive.¹⁴⁷ While some Member States allowed large flexibility on the choice of financial instruments, which were eligible for investment by UCITS, others took a more risk-averse approach with a strict adherence to the investor protection standards of the Directive.¹⁴⁸ This meant that a particular asset could be considered eligible as an investment for a UCITS in one Member State but not in another. This position was acknowledged in the Commission's 2005 Green Paper on UCITS, which suggested that the amended 1985 UCITS Directive left room for different views on whether certain categories of financial instruments could be acquired by a UCITS.¹⁴⁹ In time it became clear that minimum harmonisation was not an effective governance mechanism for mutual recognition as it left too much room for interpretation, which in turn caused regulatory arbitrage and mutual distrust between Member States. A new formula for mutual recognition had to be applied. Effective mutual recognition required a higher degree of harmonisation of regulation, which had to be combined with regulatory and supervisory convergence.¹⁵⁰

The fragmented approach to the implementation and application of the 1985 UCITS Directive as amended by the 2001 UCITS III Directives, triggered further initiatives at EU Level in this area. The Lamfalussy Process, which had been developed by EU policy-makers in 2001 as the new governance mechanism for mutual recognition in the field of financial services, was extended to the field of investment management and as a consequence to the legal framework governing UCITS. As part of this process, Europe's governance structure for the regulation of the funds industry took a step further towards integration with CESR's appointment as the Lamfalussy committee responsible for investment management having *inter alia* the responsibility of promoting harmonised practical implementation of the UCITS Directive and supervisory convergence. An additional legislative initiative was adopted by the Commission, which was sustained by CESR guidance in order to further clarify which assets were eligible for investment by UCITS. These measures sought to guarantee a certain degree of consistency in the

¹⁴⁷ P Warland, 'A useful law ruined by fudging' *Financial Times* (London 11.08.03) <www.ft.com> accessed 22.02.11.

¹⁴⁸ CESR, 'Advice to the Commission on Clarification of Definitions concerning Eligible Assets for Investments of UCITS' CESR/06-005, January 2006 <<http://goo.gl/bvWyNY>> accessed 15.03.14.

¹⁴⁹ Commission, 'Green Paper: Enhancement of the EU Framework for Investment Funds', Com(2005)314, 12.07.05 <<http://goo.gl/IbBdlC>> accessed 15.03.14.

¹⁵⁰ Commission, 'Preparing the challenge of the next phase of European capital market integration', 02.06.04 <<http://goo.gl/AE4rmt>> accessed 15.03.14.

application of the requirements of the UCITS Directive and in this way partially addressed the limitation to the governance mechanism for mutual recognition based on minimum harmonisation. In practice, however, as the 2012 UCITS VI consultation suggests, a fragmented approach to the application of the eligible assets framework applicable to UCITS remains.

The above-mentioned developments deserve to be analysed in their own right. From a historical perspective, it is however more consistent and logical to examine the 2001 UCITS Management and Prospectus Directive first. This Directive, which was adopted by the Council and the European Parliament at the same time as the 2001 UCITS Product Directive, enhanced the 1985 UCITS Directive's substantive provisions for the regulation of the management company and introduced the concept and application of a simplified prospectus which had the purpose of enhancing transparency for retail investors and consequently strengthening the protection of this category of participants in financial markets. The ultimate purpose being that of creating a more integrated and wide reaching internal market for Europe's funds industry.

3.4.3 The 2001 UCITS Management and Prospectus Directive

The 1985 UCITS Directive focused on the regulation of the financial product of the UCITS and did not contain any detailed substantive provisions for the regulation of the management company and the depositary. In this case, the approach to the creation of an internal market for financial services was different from that which had been adopted in respect of other sectors of European financial regulation, where essentially EU law focused on the regulation of the entity responsible for providing the service rather than the financial product. Moreover, the 1985 UCITS Directive prevented management companies from providing services other than collective portfolio management, being the management of collective investment schemes. It also failed to detail which services could be provided as part of the activity of collective portfolio management. Furthermore, the 1985 UCITS Directive did not provide service providers with a passport, which would have given access to the internal market. This was a limitation of the regulatory mechanism for mutual recognition in the field of UCITS.

The 1998 UCITS Management and Prospectus Proposal¹⁵¹ attempted to address these issues from a management company perspective. With regard to the possibility of a depositary passport, EU policy-makers had already expressed their clear dissent for mutual recognition in this field. This would appear to have been the reason for the Commission's decision to leave depositaries out of this initiative. One may argue that the main objective of these changes was that of creating a more harmonised regulatory framework for the more consistent supervision of management companies with a view to establishing an internal market in this field. The Proposal also recommended the creation of a framework, which would facilitate the understanding of the financial product by retail investors through the application of a simplified prospectus that would provide investors with clear, simple and essential information.

The 1985 UCITS Directive prevented management companies from providing services other than collective portfolio management, being the management of a portfolio on behalf of various investors which had pooled their assets in a collective investment scheme. The rationale behind the application of the principle of exclusivity had been the achievement of a high degree of investor protection by ensuring proper specialisation and the avoidance of possible conflicts of interest. However, in time it became clear that this policy was putting UCITS management companies at a disadvantage with other services providers. The exclusivity principle had been criticised on several occasions by the Member States and the industry as preventing important economies of scale and creating an irrational segmentation between collective and individual portfolio management¹⁵², i.e. the management of a portfolio on a client-by-client basis.

Furthermore, the 1985 UCITS Directive did not clearly define the sort of activities, which a management company could have performed as part of the service of collective portfolio management. This led to different approaches being adopted by Member States. Such differences had to be catered for if mutual recognition and the management company passport were to operate properly. The 1998 UCITS Management and Prospectus Proposal attempted to address these issues, by proposing the revision of the restriction that prevented management companies from engaging in services other than collective portfolio management. Indeed, the proposal suggested that management

¹⁵¹ Commission (n104).

¹⁵² Commission (n104) 5.

companies should be allowed to provide individual portfolio management and certain ancillary services which were at the time already provided for under the Investment Services Directive and which therefore fell within the list of services that could have been provided by investment firms and credit institutions.¹⁵³

In order to ensure consistency of regulation with investment firms and proper investor protection, the Commission suggested that the extension of the services that could be provided by management companies should be subject to the same conduct of business rules under the Investment Services Directive and capital requirements under the Capital Adequacy Directive¹⁵⁴ that are applicable to investment firms which were authorised to provide individual portfolio management.¹⁵⁵ This suggests that the Commission's aim was that of trying to avoid any possible regulatory inconsistencies between what applied to investment firms and what was to be made applicable to management companies with regard to the provision of investment and ancillary services. The Commission also made a proposal to resolve the lack of a linear approach by Member States with regard to the activities that could be performed by a management company in terms of its collective portfolio management authorisation. In this regard, the 1998 UCITS Management and Prospectus Proposal suggested that the Directive should contain a list of activities that could be provided by a management company and that subject to approval by its home financial supervisor the management company should be allowed to delegate part of its activities for the more rational organisation of its business¹⁵⁶, meaning that the delegation would optimize the management company's business function and processes.

Delegation by a management company was one of the subjects which caused much debate at European level.¹⁵⁷ Given the different legal traditions which at the time applied in Member States in this area, the 1998 UCITS Management and Prospectus Proposal recommended the application of minimum harmonisation requirements which the home financial supervisor would be required to verify before approving a mandate

¹⁵³ Commission (n104) 5.

¹⁵⁴ Directive 93/6/EEC.

¹⁵⁵ Commission (n104) 8.

¹⁵⁶ Commission (n104) 8.

¹⁵⁷ Paul (n105).

given by a management company to a third party.¹⁵⁸ The possible impact of these proposed minimum requirements on delegation given the differences in the regulatory framework of Member States was one of the points with respect to which the European Economic and Social Committee had its most serious concern, which it expressed:

Practice in Europe varies considerably. In some countries the investment management company is bound by law to undertake the activity of asset management and/or fund accounting, while in others these functions may be delegated to third parties, including delegation to the parent company of the fund management company. ... These different structures work well and provide effective investor protection. ... The Committee is, therefore, of the opinion that there is no reason for a Directive to interfere with these arrangements.¹⁵⁹

The European Parliament came to a similar conclusion. It was also pointed out that requiring the management company to obtain the financial supervisor's approval before proceeding with the delegation was too bureaucratic. This led the Commission to amend its proposal to replace the requirement for prior approval of all mandates for delegation with a rule which stipulates that the management company should provide proper information to the financial supervisor regarding the delegation in order to allow the regulator to fulfil its supervisory duties.¹⁶⁰ This position was maintained in the final text of the 2001 UCITS Management and Prospectus Directive.

The 1998 UCITS Management and Prospectus Proposal suggested the application of an authorisation procedure for management companies similar to that applied to other financial services providers in terms of other EU Directives such as the Investment Services Directive and the Second Banking Directive. It is a fundamental principle of financial regulation, that a regulatory framework should be built upon a requirement for authorisation and that the authorised entity is allowed to retain such authorisation, as

¹⁵⁸ Commission (*n104*) 13.

¹⁵⁹ European Economic and Social Committee, 'Opinion on the proposal for a Directive amending Directive 85/611/EEC with a view to regulating management companies and simplified prospectus', INT016, 24.02.99<<http://goo.gl/xWu1bJ>>accessed 15.03.14

¹⁶⁰ Commission, 'Amended proposal for a Directive amending Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions Relating to UCITS, with a view to regulating management companies and simplified prospectus', COM(2000)331, 30.05.00<<http://goo.gl/wgR1Xx>> accessed 15.03.14.

long as it remains fit and proper in terms of law and conducts its business in compliance with all the applicable requirements set in the particular regulatory regime.

In the US a management company requires a registration from the SEC as an investment adviser¹⁶¹ under the Investment Advisers Act of 1940¹⁶² ('IAA 1940'). The IAA 1940 is the last in a series of federal statutes intended to address the malpractices in the securities industry that contributed to the crisis of 1929 and the depression of the 1930's and was designed to prevent fraud and deceit by persons engaged to provide advise to investors on investments in securities.¹⁶³ The Act also came about as a consequence of the 1938-1940 SEC report on malpractices in the investment fund industry that stressed the prejudice by advisers in favour of their own financial interests.¹⁶⁴ To address these weaknesses, in terms of the IAA 1940 investment advisers owe a fiduciary duty toward their clients and are subject to detailed conduct of business rules, including the requirement to disclose the nature of their interests in transactions carried out for their clients.¹⁶⁵ As a fiduciary the adviser is required to avoid conflicts of interest with the collective investment scheme and is prohibited from overreaching or taking advantage of clients' trust.¹⁶⁶ Registration with the SEC in terms of the IAA 1940 allows the investment advisor to provide services across the US.

Within the European context, an authorisation issued by a financial supervisor in terms of a European Directive would also serve as a basis for the application of an internal market passport. The 1998 UCITS Management and Prospectus Proposal envisaged that an authorisation issued in terms of the UCITS Directive would have allowed management companies to provide their services across the EU under the freedom to provide services provisions or to establish a branch in other Member States. In the field of securities business such an internal market passport was already in operation for

¹⁶¹ IAA 1940, section 202 (11) defines an investment adviser as any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

¹⁶² For an examination of the IAA 1940 see: H Wilsey. 'The Investment Advisers Act of 1940' (1949) 4(4) *The Journal of Finance* 286-297; Cox et al (*n44*); and Plaze (*n70*).

¹⁶³ Rosenblat and Lybecker, (*n38*).

¹⁶⁴ Plaze (*n70*).

¹⁶⁵ A Dean 'Twenty-Five Years of Federal Securities Regulation by the Securities and Exchange Commission' (1959) 59(5) *Columbia Law Review* 705.

¹⁶⁶ Plaze (*n70*) 28.

investment firms under Investment Services Directive, since July 1995. This along with the experience gained through the operation of other internal market Directives in field of financial services were used as a basis for the Commission's proposed framework for the creation and operation of an internal market passport for management companies.¹⁶⁷

One of the challenges for the Commission with regard to the setting up of an internal market passport for management companies was that of limiting the possible resulting phenomenon of 'jurisdiction shopping' whereby an entity intending to be authorised as a management company to provide services in a particular Member State, but for some reason wanting to avoid the regulatory regime of that particular Member State, would apply for authorisation in another Member State and passport its activity in the former. In order to address this concern, the 1998 UCITS Management and Prospectus Proposal recommended that the European passport could only be granted by the Member State in which the management company carries out effectively the main part of its activity.¹⁶⁸ To ensure proper mutual recognition and enhance investor protection, the 1998 UCITS Management and Prospectus Proposal also contemplated the application of minimum requirements regarding the infrastructure of management companies, including specific conduct of business rules as well as capital requirements. Such requirements would help in closing the gap which existed between the UCITS Directive and the Investment Services Directive.¹⁶⁹

The proposed internal market passport would have applied to all the activities of management companies other than the management of a UCITS, which are established as a common fund. With regards to common funds the proposal still created a limitation to the passport by requiring the management company to be established in the same Member State where the contract or the unit trust was made and for the approval of the fund rules to remain within the competence of the supervisory authorities of the management company's home Member State financial supervisor. This position was criticised by the European Economic and Social Committee as creating a possible unfair distinction between those Member States where it was common practice to establish UCITS as common funds and those Member States where the investment company

¹⁶⁷ Commission (n104) 6-7.

¹⁶⁸ Commission (n104) 7.

¹⁶⁹ Paul (n105).

structure for UCITS was more widespread. Therefore, on this matter the European Economic and Social Committee concluded that the 1998 UCITS Management and Prospectus Proposal could distort the possible positive impact, which the changes could have on the internal market for financial services.¹⁷⁰ The same point was also made in the European Parliament Report on the proposal.¹⁷¹

As part of its commentary on passporting the European Economic and Social Committee also raised the issue of the depositary passport. This had formed part of the Commission's 1993 UCITS II proposal and was one of the points in respect of which there was no consensus in the Council and the European Parliament and which had brought to a close the negotiations on that proposal. For this reason the depositary passport had not formed part of the Commission's UCITS III proposal. The European Economic and Social Committee, however, still made the point that the depositary passport was fundamental for the completion of the internal market for the funds industry and therefore invited the Commission to examine ways in which passporting rights could be extended to depositaries while ensuring adequate supervisory regulation for investor protection.¹⁷²

There may have been policy reasons for requiring the depositary to be established in the same Member State of the UCITS in the initial stages of the development of the UCITS Directive, relating to the proper supervision of the UCITS product. However, as financial markets developed, the lack of an internal market passport for depositaries was increasingly becoming an anomaly. Indeed, the lack of competition in depositary business and the fragmentation in this area, were possibly responsible for inefficiencies and high costs, which in the end were being born by the investor. The European Economic and Social Committee's position seems to have reached the Council as on the adoption of the common position on the future 2001 UCITS Product Directive and the 2001 UCITS Management and Prospectus Directive, the Council also requested the Commission to submit a report on the regulation of depositaries.¹⁷³ The Commission's

¹⁷⁰ European Economic and Social Committee (*n159*).

¹⁷¹ European Parliament (*n107*) 37.

¹⁷² European Economic and Social Committee (*n159*) 4.

¹⁷³ Commission, 'Communication to Council and to European Parliament: Regulation of UCITS depositaries in the Member States', Com(2004)207, 30.03.04<<http://goo.gl/6gPrAl>>accessed 15.03.14.

work in this area is still on going and its latest initiative in this regard will be examined in the chapter 5.

Not all stakeholders were in favour of the management company passport for the purpose of providing collective portfolio management. Indeed, certain members of the funds industry had pointed out that allowing management companies to be located in a Member State which was different from that of the UCITS would have added legal, fiscal and regulatory uncertainty and risk, which in turn would have outweighed the benefits that could be derived from the application of a management company passport. This issue was also raised within CESR at the time when this supervisory committee was working on the formation of transitional arrangements from the original 1985 UCITS Directive to the UCITS III Directive. Securities regulators took the position that the legislator's did not intend to allow management companies to provide collective portfolio management on a cross border basis and therefore CESR members would only have allowed a UCITS to designate a management company in the same EU jurisdiction.¹⁷⁴

This suggests that notwithstanding the objective of the 2001 UCITS Management and Prospectus Directive to open the internal market to management companies completely, financial supervisors were not yet ready to accept mutual recognition with regards to the provision of collective portfolio management. Therefore, whilst a limitation of the regulatory mechanism for mutual recognition had been corrected, a parallel limitation of the supervisory mechanism for mutual recognition had been created. This state of affairs is indicative of how national interest and protectionism may disrupt and put limitations to the European integration process.¹⁷⁵ Indeed, the maxim that 'no-one regulates as well as we do' had thus prevailed.

This position, which partially frustrated the prospect of cross-border administrative rationalisation and the consequent efficiency gains, was eventually reversed with the adoption of the 2009 UCITS IV Directive. The said Directive sustains mutual recognition with regard to the supervision of collective portfolio management through

¹⁷⁴ CESR, 'Guidelines for supervisors regarding the transitional provisions of the amending UCITS Directives' (2001/107/EC and 2001/108/EC), CESR/04-434b 2005<<http://goo.gl/bvWyNY>>accessed 15.03.14.

¹⁷⁵ Warland (*n147*).

the application of *quasi*-maximum harmonisation organisational and conduct of business rules. This fresh initiative to achieve a management company passport will be examined in detail in a subsequent chapter of the thesis.

The 1998 UCITS Management and Prospectus Proposal also attempted to harmonise the requirements on the publication of a simplified prospectus. The transparency requirements in the 1985 UCITS Directive were based on the principle that investors should be provided with a substantial amount of detailed information, in order to allow them to make an informed investment decision. The primary aim of a prospectus is to provide investors with information about a particular financial instrument with the purpose of giving them the opportunity to assess whether or not the overall characteristics of the financial instrument fits the investor's investment objectives and risk profile. However, it was observed that the technical information included in the prospectus rendered such a document not easily understandable by the average retail investor. The prospectus was therefore not serving its purpose as it was being avoided by investors. On this basis, it was considered that the framework for investor information, provided in the 1985 UCITS Directive, was unsatisfactory from an investor protection perspective and had to be amended to allow the provision of clear, simple and essential information to retail investors. In the Commission's 1998 UCITS Management and Prospectus Proposal this information was to be provided through a simplified prospectus, a document conceived as an information document suitable for the average retail investor.¹⁷⁶

During the same period similar investor protection concerns arising from complex disclosure in the prospectus of collective investment schemes were also being discussed in the US.¹⁷⁷ Empirical research on the readability of prospectuses in the US demonstrated that investors had to have a four-year college education or higher to read and understand a prospectus.¹⁷⁸ Unsurprisingly, the simplification of disclosure in prospectuses was a top priority on the SEC's agenda.¹⁷⁹ To address these concerns the SEC amended the rules on disclosure in a prospectus to require that the language used is

¹⁷⁶ Commission (n104) 17.

¹⁷⁷ D Johnson, 'Has the SEC's Rule 421 made Mutual Fund Prospectuses more accessible? (2004) 12(1) Journal of Financial Regulation and Compliance 51-63.

¹⁷⁸ Johnson (n177).

¹⁷⁹ A Levitt, 'Take on the Street' (Pantheon 2002) chapter 'The Seven Deadly Sins of Mutual Funds' 41.

in plain English and therefore readable by investors. Collective investment schemes are also required to make available to investors a summary disclosure document which includes a concise narrative discussion of the scheme's risks and a bar chart showing the scheme's returns.¹⁸⁰ The ultimate purpose being that of making sure that less well-educated investors would be able to read and understand at least the basic information required in terms of the ICA 1940 about their investment options.

In Europe the funds industry had been actively promoting the application of a simplified prospectus as an investor protection tool.¹⁸¹ Certain Member States at national level were already requiring the preparation and distribution of a simplified prospectus.¹⁸² Harmonising the requirements with regards to the application of a simplified prospectus would have reduced costs for the industry as it would have prevented Member States from obstructing the free marketing of units in their jurisdiction by imposing additional onerous non-harmonised documentation requirements. This point was highlighted by the European Economic and Social Committee¹⁸³ and the European Parliament.¹⁸⁴ These institutions welcomed the proposed introduction of the simplified prospectus as an opportunity to simplify the marketing of funds on a cross-border basis. Such marketing had been hampered by non-standardised requirements on the provision of information to investors. It was therefore recommended that the requirements of the simplified prospectus should be exhaustive and that therefore Member States should not be allowed to require additional disclosure. To address this recommendation, in its updated 1998 UCITS Management and Prospectus Proposal the Commission clearly stated that Member States were not to be permitted to ask for further documentation.¹⁸⁵

While the concept of a simplified prospectus was innovative and should have enhanced investor protection, the implementation of this new provision of the UCITS Directive was fraught with difficulties, including differences of opinion regarding the manner in which such requirements had to be applied in practice when preparing the simplified

¹⁸⁰ SEC, 'A Plain English Handbook: How to Create Clear SEC Disclosure Documents' (1998) <<http://goo.gl/4mRmzo>> accessed 06.03.14.

¹⁸¹ EFAMA, 'The Simplified Prospectus: Policy Paper', 23.10.06 <<http://www.efama.org>> accessed 28.11.10.

¹⁸² Commission (n104) 9-10.

¹⁸³ European Economic and Social Committee (n159).

¹⁸⁴ European Parliament (n107) 37.

¹⁸⁵ Commission (n160) 7.

prospectus.¹⁸⁶ The inconsistent manner in which the requirements on the simplified prospectus were implemented is yet another example of how a measure which was introduced to establish harmonisation and consistency with the final aim of achieving integration was changed into a means of protecting the national industry, by applying such requirement in a way which distorts cross-border business. This led the Commission to issue further clarification regarding the content and presentation of certain elements of information which had to be included in the simplified prospectus.¹⁸⁷ The objective was to ensure a common reading of what the simplified prospectus ought to contain and ensure a harmonised approach in this regard. Still, Member States did not adopt a consistent approach to the implementation of the Commission's recommendations. In time, it became clear that the simplified prospectus had failed to deliver its objective of being an investor friendly document.¹⁸⁸ Indeed, what was intended to be a short document, which provides clear information on the essentials that an investor should be aware of before investing in a UCITS, became in practice a long, legally worded document prepared in a non-standardised format and too complex to be understood by investors.

This state of affairs led to another initiative in this area and the eventual replacement of the simplified prospectus with the key investor information document as crystallised in the 2009 UCITS IV Directive. The requirements of the key investor information document and the changes to the governance mechanism for mutual recognition which were implemented as part of the process which led to its adoption are analysed in chapter 5.

¹⁸⁶ D Rouch and K Smith, 'The UCITS Directive and the single European funds market: a case review' (2005) 20(6) *Journal of International Banking Law and Regulation* 259.

¹⁸⁷ Commission Recommendation of 27.04.04 on some of the contents of the simplified prospectus as provided for in Schedule C of Annex I to Directive 85/611/EEC (2004/384/EC).

¹⁸⁸ Commission, 'Workshops on simplified prospectus – Summary of the meetings held on the 15.05.06 and 11.07.06' <www.europa.eu> accessed 24.02.11.

3.5 Conclusion

This chapter analysed the development of the governance mechanism and the regulatory framework for mutual recognition during the first two decades of the UCITS Directive. It examined the three conditions for the functioning of mutual recognition during this period being: minimum harmonisation of regulation; home country control; and complementary host country supervision. It also identified and examined the limitations of the governance mechanism and the regulatory framework for mutual recognition.

In conclusion, it is reasonable to state that the early stages of the internal market for UCITS were characterised by a slow law-making process for the regulation of financial services, detailed negotiations and compromises between Member States. These resulted in the adoption of ambiguous and suboptimal requirements, which granted discretions to Member States leading to uneven implementation and the inconsistent interpretation of the provisions of UCITS Directive.

It is also reasonable to conclude that during this period Member States were more inclined to protect national industries rather than sharing their regulatory and supervisory sovereignty in the interest of a broader and more robust internal market. In this regard, Member States applied opportunistic interpretations of ambiguous requirements in order to gold-plate and by so doing protect national practices and institutions. National agendas distort the integration of European financial markets and create barriers to the development of the internal market.

Moreover, the lengthy period of time, which had to elapse before a compromise could be reached with regard to the revamp of the 1985 UCITS Directive, is indicative of the limitations of the EU legislative process applicable at the time in this field, which in itself worked as yet another central barrier to the creation of a true internal market for financial services. Indeed, after sixteen long years of stagnation, the 2001 UCITS Directives were a crucial step for unblocking the road towards further integration of the European funds industry.

The adoption of the 2001 UCITS Directives and the consequent widening of the array of financial instruments in which a UCITS could invest, the introduction of a passport for

management companies and the application of a harmonised simplified prospectus were in principle a positive step in the creation of an internal market for the European funds industry. However, as examined in this chapter, the unharmonised implementation of the provisions of the Directive by the Member States created new operational and regulatory barriers to the cross-border activity by UCITS, which greatly reduced the effectiveness of mutual recognition in this field.

In the final analysis, while the 1985 UCITS Directive and subsequent amendments were a necessary first step in the process for the development of an internal market for UCITS, the limitations of the governance mechanism for mutual recognition, in the form of inconsistent application of the Directive and the application of Member State discretions, raised barriers to the internal market for UCITS. This state of affairs, together with a general acceptance of the failures of the legislative process in achieving updated regulation which could keep the pace with the fast developments in financial markets, led to the establishment of a new governance mechanism for mutual recognition in field of financial services.

Chapter 4

FROM MINIMUM HARMONISATION TO THE LAMFALUSSY PROCESS: AN ANALYSIS OF THE MECHANISM FOR A HIGHER DEGREE OF MUTUAL RECOGNITION IN THE FIELD OF UCITS

4.1 Introduction

Chapter 4 examines the Lamfalussy Process¹ and the manner in which this was applied in the context of the 2009 UCITS IV Directive². The resulting governance mechanism for a higher degree of mutual recognition in the field of UCITS is also considered.

The Lamfalussy Process was developed by a Committee of Wise Men, which was established by the EU Institutions at the start of this century, with the purpose of making recommendations for a more effective governance mechanism in the field of financial regulation and supervision. The Committee recommended a substantial change in the conditions for mutual recognition, from minimum harmonisation to a higher degree of harmonisation, *quasi*-maximum harmonisation, complemented by regulatory and supervisory convergence. *Quasi*-maximum harmonisation is a technique composed of a mixture of minimum and maximum harmonisation provisions. The development of the Lamfalussy Process formed part of a wider project for more efficient and transparent governance, constructed by the EU at the beginning of this century, which included the structure for an open method of co-ordination.³

In 2009, the 1985 UCITS Directive was recast into a Lamfalussy Directive. The Directive established a regulatory framework for a more efficient passport for UCITS while stipulating the tools for the consolidation of funds of sub-optimal size.

¹ Committee of Wise Men (Lamfalussy Group), 'Initial Report', Brussels 09.11.00 <<http://goo.gl/qHT2FV>>accessed 15.03.14.

² Directive 2009/65/EC.

³ Commission, 'White Paper on European Governance', COM(2001)Final, 25.07.01 <<http://goo.gl/Q4Cr7F>>accessed 15.03.14

The chapter analyses the nature and operation of the governance mechanisms applied under the Lamfalussy Process and examines the effectiveness of this process in the construction of the regulatory framework of the 2009 UCITS IV Directive. The conditions and limitations of the Lamfalussy Process in the context of mutual recognition are also identified and analysed.

The central argument of the chapter is that the Lamfalussy Process established the tools for the strengthening of mutual recognition between Member States and, by so doing, created the right environment for the creation of a broader internal market in the field of UCITS. It is argued that the success of the Lamfalussy hard-law making process in achieving *quasi*-maximum harmonisation as applied in the context of the 2009 UCITS IV Directive, was due to the fact that it was transparent and promoted a wide inclusive debate which allowed for both technical and political considerations to be made. The chapter emphasises the point that the different elements of the Lamfalussy Process, complement each other and that unless all of them are allowed to operate effectively, the legislative process will lose on its efficiency.

The Lamfalussy Process has been in operation for more than a decade. Therefore, it may be relevant and useful to consider the distinguishing characteristics of such mechanisms as existed before the Treaty of Lisbon and those which were created and introduced later. Although the major academic debate on this topic has revolved around the institutional balance of power within the context of the hard-law making process⁴, it is not within the scope of the thesis to contribute to this debate. However, new elements that transpired following inter-institutional tensions over the structure of the control mechanisms for the law-making process are highlighted, since they are relevant to the

⁴ C Joerges and J Neyer, 'From Intergovernmental Bargaining to Deliberative Political Processes: The Constitutionalisation of Comitology' (1997) 3(3) *European Law Journal* 273-299; C Bates, 'European Regulation: Time to Deliver?' (2002) 17(2) *Journal of International Banking and Financial Law* 65; C Bergström, '*Comitology: Delegation of Powers in the European Union and the Committee System*' (Oxford 2005); F Franchino, '*The Powers of the Union: Delegation in the EU*' (Cambridge 2007); C Bergström, H Farrell, and A Héritier, 'Legislate or Delegate? Bargaining over Implementation and Legislative Authority in the EU' (2007) *European Politics* 338-366. A Heritier, 'Institutional Change in Europe: Co-decision and Comitology Transformed' (2012) 50(Supplement1) *Journal of Common Market Studies* 38-54; T Christiansen and M Dobbels 'Comitology and delegated acts after Lisbon: How the European Parliament lost the implementation game' (2012) *European Integration Papers* <<http://eiop.or.at/eiop/texte/2012-013a.htm>>; and G Brandsma and J Blom-Hansen, 'Negotiating the Post-Lisbon Comitology System: Institutional Battles over Delegated Decision-Making' (2012) 50(6) *Journal of Common Market Studies* 939-957.

overall discussion on the effectiveness of the Lamfalussy Process as a governance mechanism for mutual recognition.

The chapter also examines the soft-law mechanisms established by the Lamfalussy Process and points out that while soft-law mechanisms are an effective method in attaining flexibility, which is critical to keep up with developments in financial markets, the unenforceability of soft-law may create legal uncertainty that may put into danger part of the harmonisation process. This, in turn, damages the mutual recognition process between the Member States. Another limitation of the soft-law mechanism under the Lamfalussy Process is that it mainly focused on measures intended to achieve regulatory convergence, with little or no effort in the field of supervisory convergence.

Centralisation of financial supervision is an alternative model to convergence. In this connection, the chapter examines the role of ESMA and the limitations to its discretionary powers as a result of the *Meroni* doctrine. Given the dynamic nature of the financial system, financial supervision must be in a position to adapt to changing circumstances. Therefore, supervision is an activity that requires a high level of discretion. After the Court of Justice of the EU ('CJEU') ruling in *UK v Council and European Parliament* [C-270/12] the time may be ripe for a reconsideration of the discretionary powers granted to ESMA together with the overall European governance structure for regulation and supervision and more specifically, the division of tasks between ESMA and national financial supervisors. For this purpose the tools provided by the economics of federalism as encapsulated in the principle of subsidiarity are applied. The chapter proposes a governance model for European supervision of securities regulation whereby large cross-border operators would be supervised by ESMA, while other operators would continue being supervised at national level. The analysis and the resulting proposal are important for a better understanding of the mechanisms for European supervision in general and of UCITS in particular. As an integral part of the analysis a comparison with the US has been carried out and some important lessons have been drawn from the experience across the Atlantic.

Chapter 4 is divided into five additional sections. Section 4.2 provides a brief introduction to the Lamfalussy Process. Section 4.3 examines the governance mechanisms for a *quasi*-maximum harmonisation of regulation. Section 4.4 analyses the

mechanisms for regulatory and supervisory convergence. Section 4.5 examines the mechanisms for enforcement. Concluding remarks are made at the end of the chapter.

The analysis in chapter 4 aims at drawing specific conclusions on the operation of the Lamfalussy Process as it was applied to the 2009 UCITS IV Directive. The analysis is critical to the debate on the evolution of the conditions and limitations of the governance mechanism for mutual recognition.

4.2 Lamfalussy Process: A Governance Mechanism For A Higher Degree of Mutual Recognition

By the mid-1990's, it became apparent that the governance mechanism for EU financial regulation devised by the 1985 Cockfield White Paper was inadequate to keep up with the developments in global financial markets.⁵ Furthermore, the legislative programme, which emerged from the 1985 initiative, had not proved to be sufficiently effective in terms of internal market integration in financial services.⁶ The limitations of the governance mechanism for EU financial regulation had to be addressed if the regulatory framework was to keep pace with potential developments, such as the introduction of the euro, which would in future contribute to the development of the internal market.⁷ These considerations triggered a debate on the future of financial regulation.

The resulting deliberations concluded that the governance mechanism for EU financial regulation was too slow. The standard amount of time engaged for a co-decision procedure, from the Commission's proposal to final agreement, took on average over four years.⁸ The transposition of Directives into national law was taking overall five years to complete.⁹ It was also realised that the legislative framework was too rigid with every change, however small or technical, requiring a full-blown Commission proposal

⁵ D Alford, 'The Lamfalussy Process and EU Bank Regulation: Another Step on the road to pan-European Regulation?' (2006) Annual Review of Banking and Financial Law 398.

⁶ K Lanoo and M Levin, 'Securities Regulation in the EU: The Relation Between the Community and Member States' (2004) Centre for European Policy Studies<www.ceps.be>08.04.12.

⁷ N Moloney, 'The Lamfalussy legislative model: A new era for EC securities investment services regime' (2003) 52(2) International and Comparative Law Quarterly 510.

⁸ M Warren III, '*European Securities Regulation*' (Kluwer Law 2003) 8.

⁹ C Goodhart, 'The political economy of financial harmonisation in Europe', in J Kremers, D Schoenmaker and P Wietrts (eds), '*Financial Supervision in Europe*', (Edward Elgar 2003) 4.

to be negotiated by co-decision.¹⁰ Furthermore, the resulting EU financial regulation allowed several national discretions, which created ambiguity and resulted in an uneven implementation by the Member States.¹¹ This undesired outcome was also due to the lack of a common interpretation of EU financial regulation and an absence of proper coordination between national financial supervisors.

These limitations weakened the governance mechanism for mutual recognition between the Member States and as a result created additional barriers to the development of the internal market. The uneven implementation and the different interpretations and manners of application of EU financial regulation, continued to surface as the basis for Member States to lift the obligation for mutual recognition. At the time, it was not rare for a host financial supervisor not to accept a passported financial institution, as it regarded the home Member State's regulatory framework as having incorrectly applied EU regulation.¹² The key question remained: Why should a Member State allow a financial institution from another jurisdiction to access its market, when it does not trust the extent of investor protection afforded in that jurisdiction?

A Committee of Wise Men was set up by the Council in July 2000, to establish and examine the weaknesses in the governance mechanism for financial regulation. The Committee analysed the conditions for implementation of financial regulation by the Member States, the EU's regulatory capacity to cope with developments in financial markets and the scenarios for adapting the governance mechanism for financial regulation with a view to creating a more uniform regulatory framework and ensuring greater convergence and cooperation in day-to-day implementation.¹³ Their findings confirmed the criticism of the existing governance mechanism. The Committee concluded:

... the European Union's current regulatory framework is too slow, too rigid, complex and ill-adapted to the pace of global financial market change. Moreover,

¹⁰ B Inel, 'Assessing the first two years of the new regulatory framework for financial markets in Europe' (2003) 18(9) *Journal of International Banking Law and Regulation* 363–369.

¹¹ E Ferran, 'Building an EU Securities Market' (Cambridge 2004) 4–5.

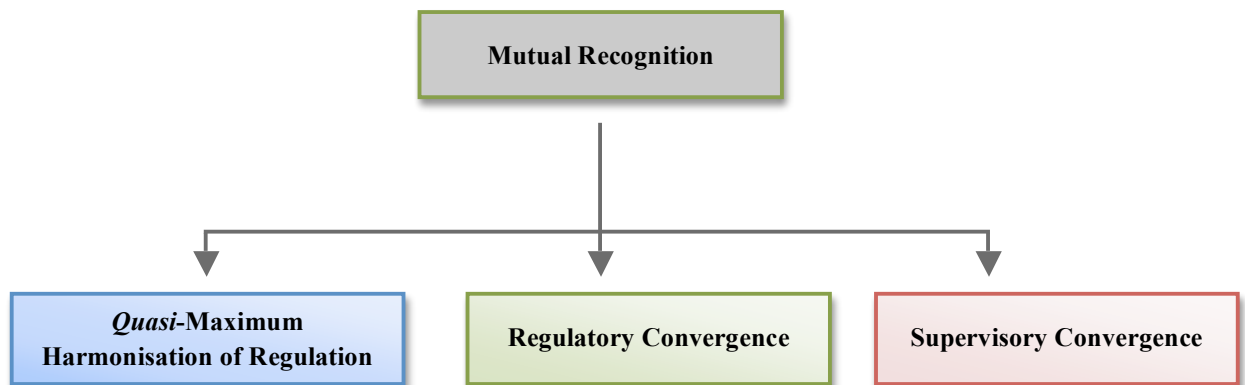
¹² M Ortino, 'The role and functioning of mutual recognition in the European market of financial services' (2007) 56(2) *International & Comparative Law Quarterly* 327.

¹³ Lamfalussy Report (*n1*).

... existing rules and regulations are implemented differently and that therefore inconsistencies occur in the treatment of the same type of business, which threatens to violate the pre-requisite of the competitive neutrality of supervision. ... The problem is the system itself. ...¹⁴

The Committee's view, points towards a concern that the governance mechanism for financial regulation had become a conduit for regulatory arbitrage and had given Member States the opportunity to pursue national agendas that favoured lax supervision to protect the national industry. The Committee made proposals to address these weaknesses through a restructuring of the mechanism, by replacing the policy favouring minimum harmonisation with a policy that promotes *quasi*-maximum harmonisation combined with regulatory and supervisory convergence.

Diagram 4.1 - Conditions for Mutual Recognition under the Lamfalussy Process



The primary objective of the Lamfalussy Process was that of achieving more harmonised financial regulation at a rapid pace.¹⁵ The process rested on a governance mechanism for financial regulation that works on the basis of the principles of transparency and consultation with stakeholders; inclusive technical and political debate; and inter-institutional cooperation. The quality of transparency, consultation, debate and cooperation between all relevant parties being the key elements for a more effective law-making process, which generates better and faster financial regulation that

¹⁴ Lamfalussy Report (n1) 7.

¹⁵ A Schaub, 'The Lamfalussy process four years on', (2005) 13(2) Journal of Financial Regulation and Compliance 111.

instills a higher degree of mutual trust between the Member States. These principles were at the heart of the new governance roadmap, which the EU was implementing in the aftermath of the legitimacy crisis, that had been caused by the sacking of the Santer Commission by the European Parliament in the late 1990's¹⁶ and the concerns on the democratic processes raised by the Irish 'No' to the Nice Treaty.¹⁷

The Lamfalussy Process sought to ensure that:

The barriers – unnecessary bureaucracy, lack of trust, and sometimes downright protectionism – will become things of the past.¹⁸

It is debatable whether the Lamfalussy Process managed to deal effectively with all the underlying causes of the limitations of the governance mechanism for EU financial regulation. Nonetheless, to achieve the desired outcome, the process was structured into a four level governance mechanism based on a rethink of the form which financial regulation should take and the manner in which it should be adopted and eventually implemented.¹⁹ The governance mechanism for financial regulation was subdivided into:

- Level 1 financial regulation setting out general principles, adopted by the Council and European Parliament using the co-decision procedure. In general, it was intended that Level 1 should only include basic political choices that can be articulated as broad, but sufficiently precise, framework rules;
- Level 2 implementing measures to underpin the Level 1 framework rules, to be adopted by the Commission through the application of the comitology procedure. The scope of Level 2 is determined at Level 1 that specifies the nature and the extent of the implementing measures that may be adopted and the limits within which the resulting provisions can be adapted and updated at that level without requiring a change to Level 1;

¹⁶ M Dawson, 'Three waves of new governance in the European Union' (2011) 36(2) *European Law Review* 208–225.

¹⁷ Commission (*n3*) 3.

¹⁸ Lamfalussy Report (*n1*) 9.

¹⁹ Moloney (*n7*) 511.

- Level 3 regulatory and supervisory convergence of financial regulation, through strengthened cooperation between financial supervisors; and
- Level 4 strengthened enforcement of financial regulation by the Commission.²⁰

The four levels of the governance mechanism for financial regulation sought to establish the conditions for mutual recognition by way of more extensive harmonisation of Regulation at Level 1 and 2, complemented by regulatory and supervisory convergence at Level 3 and enforcement at Level 4. The Lamfalussy Process required the establishment of two Committees to assist the Commission in its legislative initiatives, the ESC and CESR. These were created in 2001.²¹

The ESC, which is composed of Member State representatives, acts as an advisory and regulatory committee under the comitology procedure and is chaired by the Commission.²² The comitology procedure is the Member States' control mechanism over the Commission's legislative powers.²³ The theories on the transfer of legislative powers to the executive, suggest that when the legislator has reason to believe that the executive will make decisions that it would disagree with, the legislator will not grant autonomous legislative discretion to the executive.²⁴ The comitology procedure applies where legislative powers are granted to the Commission. It is a governance mechanism, which was set up in response to the duplicate need to achieve more efficient EU decision-making, while at the same time allowing the Member States a certain degree of control over the legislative process.

The application of the comitology procedure within the Lamfalussy Process was therefore a practical solution for the Member States' concern about conferring legislative powers to the Commission without losing control. The ESC, which is a

²⁰ Schaub (*n15*).

²¹ D Rouch & K Smith, 'The UCITS Directive and the single European funds market: a case review' (2005) 20(6) *Journal of International Banking Law and Regulation*.

²² Commission Decision 2001/528/EC.

²³ K Lanoo and M Levin, 'Everything you always wanted to know about the Lamfalussy Procedure' (2004) CEPS Research Report <www.ceps.be> accessed 10.04.13.

²⁴ D Epstein and S O'Halloran 'Divided Government and the Design of Administrative Procedures' (1996) 58(2) *The Journal of Politics* 373-397.

committee that allows a certain degree of political debate to take place at level 2, functions as a miniature Council and has the right to vote on Level 2 measures before the proposed rules may be adopted by the Commission.²⁵ The political debate at Level 2 is a key element of the Lamfalussy formula, which allowed the law-making process at Level 2 to operate effectively. Nonetheless, the role of the ESC diminished after the Treaty of Lisbon.

The technical debate on legislative proposals, which was another key element of the formula for an effective law-making process at Level 2, took place within CESR. This Committee brought together under one roof the financial supervisors of the Member States to discuss and resolve matters in the field of financial regulation and supervision thereby seeking to strengthen mutual trust between Member States. The nature of the Committees such as CESR, may be explained on the basis of the theoretical framework on governance networks.²⁶ Governance networks are collective arrangements which bring together officials from like agencies coming from across borders, with the purpose of discussing and responding to international issues, seeking to close gaps through co-ordination and in so doing, establishing a new sort of power, authority and legitimacy. These governance networks promote the accomplishment of co-ordination on an international level and establish a new mechanism for the development of coherent standards.

CESR had the general function of advising the Commission in the field of financial markets and was consulted by the Commission on such issues, in particular in the preparation of draft implementing measures at Level 2. CESR was chosen as the principal advisor to the Commission, because national financial supervisors are responsible, at law, for the day-to-day application of the provisions which the Commission proposes to adopt.²⁷ Therefore, a national financial supervisor would only recommend the adoption of rules that can be implemented in practice, making the outcome of the legislative process more efficient.

²⁵ Decision 1999/468/EC and T Christiansen and T Larsson, *The Role of Committees in the Policy-Process of the European Union* (Edward Elgar, 2007).

²⁶ A Slaughter, *A New World Order* (Princeton University, 2004).

²⁷ A Lamfalussy, 'Towards an Integrated European Financial Market' (2001) *The World Economy* 1287-1294; and G Wittich, 'Implementing the Lamfalussy Report: The Contribution of Europe's Securities Regulators' (2001) 3(6) *Journal of International Financial Markets* 209-213.

At Level 3, CESR functioned as a new governance type open method of co-ordination mechanism, along side the traditional Community Method for the adoption of binding EU legislative, administrative and judicial rules.²⁸ It had the fundamental role of deepening the co-operation arrangements between national financial supervisors to enhance the supervisory relationship between authorities and improve convergence of supervisory approaches and decisions.²⁹ Convergence of supervisory practices and supervisory cooperation were considered as critical for strengthening mutual recognition between Member States, as they militated towards the achievement of competitive neutrality of supervision. The Lamfalussy report expressed the concern that:

Today, there are about 40 public bodies in the European Union dealing with securities markets regulation and supervision. Competences are mixed. Responsibilities are different. The result at European level is fragmentation and often confusion. More convergent regulatory and supervisory structures are vital to ensure that the [internal market] can function effectively.³⁰

The setting up of CESR was also an effort to address this concern, as CESR sought to create a governance mechanism for the promotion of an environment of discussion and cooperation between national financial supervisors, which reinforces mutual trust and the proper operation of the internal market.³¹ The significance of CESR was that it acted as a mechanism for the pooling of knowledge between supervisors for the resolution of common difficulties that may be encountered in day-to-day supervision. Thereby, another line of multilevel governance in the EU was created, characterised by the relationship between EU institutions and institutions in Member States, which offers a mode of decision-making that aims at avoiding the rigidities of the traditional hard-law form of financial regulation.

²⁸ G De Burca, 'The Constitutional Challenge of New Governance in the EU' (2003) 28(6) *European Law Review* 814-839; S Deakin, 'Reflexive Governance and European Company Law' (2009) 15(2) *European Law Journal* 224-225; and E Szyszczak, 'Experimental Governance: The Open Method of Coordination' (2006) 12(4) *European Law Journal* 486-502.

²⁹ CESR, 'The Role of CESR at 'Level 3' Under the Lamfalussy Process – Action plan for 2005', (2004) CESR/04-527b 4-5 <<http://goo.gl/bvWyNY>> accessed 15.03.14.

³⁰ Lamfalussy Report (*n1*) 15-16.

³¹ C McCreedy, 'The New Global Regulatory Agenda in Financial Services' (2006) 9(3) *International Finance* 386.

The following two sub-sections examine the effectiveness of the four level governance mechanism set by the Lamfalussy Process to achieve *quasi*-maximum harmonisation. The analysis will seek to examine the factual application of the principles set by the Lamfalussy Process, and the extent to which: **[i]** transparency and consultation with stakeholders; **[ii]** inclusive technical and political debate; and **[iii]** inter-institutional cooperation, have been effectively put into effect.

As part of this process the conditions and limitations of the Lamfalussy formula for mutual recognition are examined.

4.3 Level 1 and 2: Governance Mechanisms for *Quasi*-Maximum Harmonisation

At Level 1 and 2, the Lamfalussy Process was devised to operate a transparent and upward directed approach. The importance of transparency in the law-making process stems from its relevance in the accomplishment of other essential principles of regulation, such as ease of access, clarity, logic, consistency, honesty and precision, as well as openness.³² These features along with transparency create a legitimising effect and strengthen mutual trust between Member States. It was therefore logical to require that the process at Level 1 and 2 should be initiated by way of a consultation and the holding of specific meetings with stakeholders with a view to debating the main issues that might concern the legislative initiative. Consultation of stakeholders would ensure that the governance mechanism for financial regulation is more democratic and that the outcome of the process should therefore be more acceptable to the industry. Albeit, as the capture theory of financial regulation warns, regulators should never get too close to the industry.

While remaining open to listen to what the industry has to say, in order to realise the objective of achieving the common good, a regulator should always remain and be perceived as being aloof. At the end of a consultation process the regulator should exercise independent judgement, particularly when determining the objectives, scope and extent of financial regulation. On the other hand, the term stakeholder in the context

³² R Weber, 'New rule-making elements for financial architecture's reform' (2010) 25(10) Journal of International Banking Law and Regulation 512–521.

of the Lamfalussy Process does not solely refer to the industry but includes all participants in the financial system including investors. Indeed, stakeholder activity under the Lamfalussy Process may be understood on the basis of the theoretical framework termed the multi-stakeholder approach, which recommends the application of a more cooperative attitude towards the inclusion of non-governmental organisations and interest groups in the rule-making process.³³ As the experience derived from the process which led to the adoption of the 2009 UCITS IV Directive suggests, the active involvement of stakeholders and the transparency of the process contribute to the widening of the debate on financial regulation, which, in turn, benefits the effectiveness of the overall law-making process.

Transparency of documentation relating to a legislative process is required in terms of EU legislation on procedure and is not a matter that is exclusive to the Lamfalussy Process.³⁴ Transparency of the process at Level 1 and 2, is *inter alia* achieved through the internet web-page of the EU institutions and the European and national authorities. An examination of the content of the relevant internet web-pages reveals the manner of operation of this mechanism and the extent of transparency achieved in practice. Empirical evidence from this exercise, particularly in the context of the 2009 UCITS IV Directive, demonstrates that at every stage of the legislative process and irrespective of the EU institutions involved, documentation providing information on the status of the process and the development of proposed legislation was made public and available to stakeholders.³⁵ This level of transparency demonstrates an overall effort to allow stakeholders the opportunity to follow the development of the legislative process, thereby strengthening the legitimacy and acceptability of the outcome of such process.

³³ Weber (*n32*) 516.

³⁴ Regulation (EC) No1049/2001.

³⁵ Links to the relevant section of the web-sites of the Commission<<http://goo.gl/ETkcSI>>; the Council <<http://goo.gl/NmwId3>> and the European Parliament<<http://goo.gl/chGXfp>>all web-sites were originally accessed 05.02.12.

4.3.1 Transparency at Level 1 – The UCITS IV Directive

At Level 1, before making the proposal for a UCITS IV Directive which was published in 2008³⁶, the Commission sought the views of all stakeholders through a long process of consultation in various stages, which took approximately four years to complete.³⁷ As part of this process the Commission: appointed expert groups on investment management to report on the level of integration and the future of the regulation of investment management in the EU³⁸; issued a Green Paper³⁹ and a White Paper⁴⁰ on the enhancement of the framework for investment funds in Europe; and organised bilateral meetings with stakeholders, open hearings⁴¹ and a number of workshops.⁴² The process brought together all the different stakeholders, including policy-makers, the national financial supervisors, the industry and the investors. It stimulated a debate on priorities and the extent of future financial regulation in the field of UCITS, thus helping to shape the direction of the future proposal for a UCITS IV Directive.

4.3.2 Transparency at Level 2 – The UCITS IV Directive

At Level 2, a significant effort was again put into generating debate through consultation and transparency in the process for the adoption of the implementing measures under the 2009 UCITS IV Directive. As part of the process, CESR published an initial call for evidence⁴³ and three consultation documents.⁴⁴ It also organised two

³⁶ Commission, 'Proposal for a Directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities' COM(2008)458, 16.07.08<<http://goo.gl/VMfhvX>>accessed 15.03.14.

³⁷ Commission, 'Impact assessment: of the Legislative Proposal Amending the UCITS Directive' SEC(2008)2263 16.07.08. See in particular annex 1 on procedural issues and interested parties 37–42 <<http://goo.gl/VMfhvX>>accessed 15.03.14.

³⁸ In January 2006, the Commission appointed experts on investment fund market efficiency and alternative investments to analyse ways in which the European environment for their sector could be improved<<http://goo.gl/hsKRn3>>accessed 14.04.13.

³⁹ Commission, 'Green Paper: Enhancement of the EU Framework for Funds' COM(2005)314, 12.07.05. <<http://goo.gl/IbBdlC>>accessed 15.03.14.

⁴⁰ Commission, 'White Paper: Enhancing the single market Framework for Funds' COM(2006)686, 15.11.06<<http://goo.gl/cALb0p>>accessed 15.03.14.

⁴¹ As part of the Commission's consultation process, two open hearings were hosted by the Commission on 13 October 2005 and 19 July 2006. More information available at<<http://goo.gl/9WS7FN>>accessed 14.04.13.

⁴² A detailed explanation on the level of consultation is available in the Impact Assessment (n37) 37–42.

⁴³ CESR, 'Call for Evidence on Possible Implementing Measures concerning the UCITS Directive' CESR/09-179, 17.02.09<<http://goo.gl/bvWyNY>>accessed 15.03.14.

open hearings.⁴⁵ Again, a review of the documentation generated as part of the process brings to bear a high level of debate between the relevant parties, particularly on the possible costs and benefits of CESR's proposals. The outcome of this debate and the Commission's adherence to CESR's advice on the Level 2 measures under the 2009 UCITS IV Directive, validate the importance of a wide and inclusive debate on the technical details which give shape to a legislative proposal at Level 2.

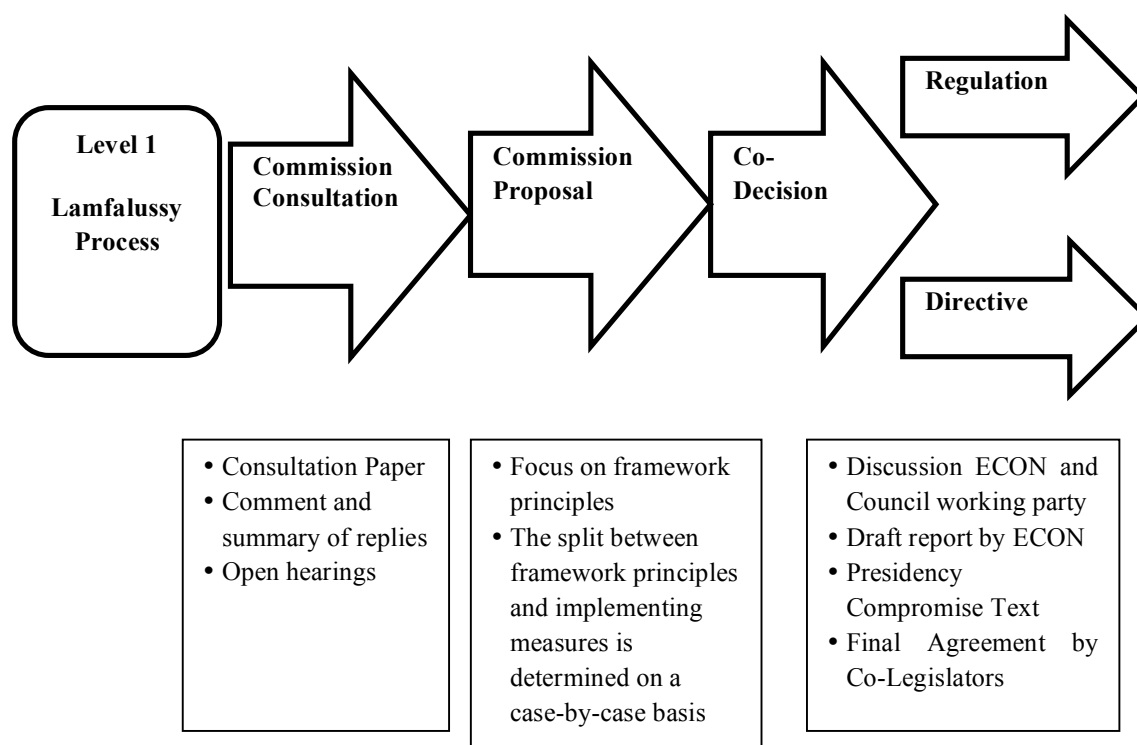
4.3.3 The Structure of the Debate at Level 1

In terms of the structure of the debate at institutional level, the benefit of limiting Level 1 to framework rules is that of restricting the difficult and sometimes lengthy political co-decision negotiations between the Council and the European Parliament, thus focusing only on the essential issues and not on technical details.⁴⁶ Through this mechanism, the Lamfalussy Process sought to achieve speedier negotiations at Level 1 and a more efficient governance mechanism for financial regulation. The Level 1 mechanism for law-making is explained in the following diagram.

⁴⁴ CESR, 'Consultation Paper: CESR's technical advice to the European on the level 2 measures related to the UCITS management company passport' CESR/09-624, 08.07.09; Consultation paper: CESR's technical advice to the European Commission on level 2 measures relating to mergers of UCITS, master-feeder UCITS structures and cross-border notification of UCITS' CESR/09-785, 17.09.09; and Consultation Paper: CESR's technical advice at level 2 on Risk Measurement for the purposes of the calculation of UCITS' global exposure CESR/09-489, 15.06.09<<http://goo.gl/bvWyNY>>accessed 15.03.14.

⁴⁵ An open hearing on the KIID was held on the 17.11.07 and an open hearing on the UCITS management company passport was held on the 23.09.09. Information about these open hearings is available<www.esma.europa.eu>accessed 14.04.13.

⁴⁶ A Doctors van Leeuwen and F Demarigny, 'Europe's securities regulators working together under new EU regulatory framework', (2004) 12(3) Journal of Financial Regulation and Compliance 207. Also see Federation of European Stock Exchanges, 'A European Agenda For Financial Services: FESE's post-FSAP Priorities' November 2004<www.fese.org>accessed 08.04.13.

Diagram 4.2 - The Level 1 Law-Making Mechanism

A review of the details contained in the Directives adopted at Level 1 during the FSAP phase of the Lamfalussy Process reveals a rather different story. In practice, more often than not, the discussion at Level 1 was extended to technical issues and resulted in the drafting of legal texts, which, in part, could have been addressed at Level 2.⁴⁷ This is also the case of the 2009 UCITS IV Directive, which contains an annex that prescribes the information to be included in a prospectus of UCITS, that could have been considered at Level 2. The content of the annex may easily qualify as substantive regulation that falls within the category of measures, designed to amend non-essential elements of the Directive. Similar substantive regulation applicable to issuers of financial instruments, regulated in terms of the PD⁴⁸, was adopted in the form of an implementing regulation issued at Level 2.⁴⁹ This therefore is a factual example of an area of regulation applicable to UCITS that was incorporated in the Level 1 text, but which could have been incorporated in the measures considered at Level 2. It also reveals a certain degree of inconsistency between the approach to substantive regulation adopted in different circumstances.

⁴⁷ D Alford, 'The Lamfalussy process and EU bank regulation: preliminary assessment and future prospects' (2006) 21(2) *Journal of International Banking Law and Regulation* 65.

⁴⁸ Directive 2003/71/EC.

⁴⁹ Regulation (EC) No809/2004.

The additional layer of regulation at Level 1 goes against what had been highlighted and recommended by EU inter-institutional review of the Lamfalussy Process, which pointed out that:

Excessive detail, though, has not been fully avoided ... in Level 1 legislation ... The Group believes that the European co-legislators should avoid to the greatest extent possible the inclusion of technical rules in framework legislation.⁵⁰

The reluctance may suggest that implementing measures are also likely to raise political considerations, over which the Council and the European Parliament would want to retain full control and which are unlikely to be left at the discretion of the Commission. It reveals the tensions that exist and which have actually escalated since the adoption of the Treaty of Lisbon, between the EU institutions, particularly with regard to the conferring of legislative powers to the Commission, a delicate matter which is also at the heart of the discussions regarding competence between the EU on the one hand and the Member States on the other.

This point also raises the critical question regarding how, from a technical point of view, one should distinguish between substantive regulation which may fall under the category of basic framework principles on the one hand, and regulations which may be categorised as implementing measures on the other. The technical answer lies within the Treaty, which restricts the transferring of legislative powers to the Commission to non-essential rules. It stipulates that:

... the essential elements of an area [of regulation] shall be reserved for the legislative act and accordingly shall not be the subject of a delegation of power.⁵¹

The European Court of Justice ('ECJ') defined 'essential elements' as those which:

... must be reserved for provisions which are intended to give concrete shape to

⁵⁰ Inter-Institutional Monitoring Group, 'Final Report Monitoring the Lamfalussy Process', Brussels, 15.10.07<<http://goo.gl/JrYCuG>>accessed 15.03.14.

⁵¹ TFEU, Article 290 (1).

the fundamental guidelines of Community policy.⁵²

Therefore, the essential elements of a piece of EU legislation, which the legislature cannot confer to the Commission, are the material, geographical or temporal scope of such legislation. The material scope of the legislation is the subject matter of the regulation. In the context of financial services, it refers to the major dimensions of the financial activity to which the provisions of the specific piece of law apply. The temporal scope of a piece of legislation relates to the date of entry into force and its duration if this has been determined. The geographical scope of a piece of legislation identifies those Member States that are required to abide by it.

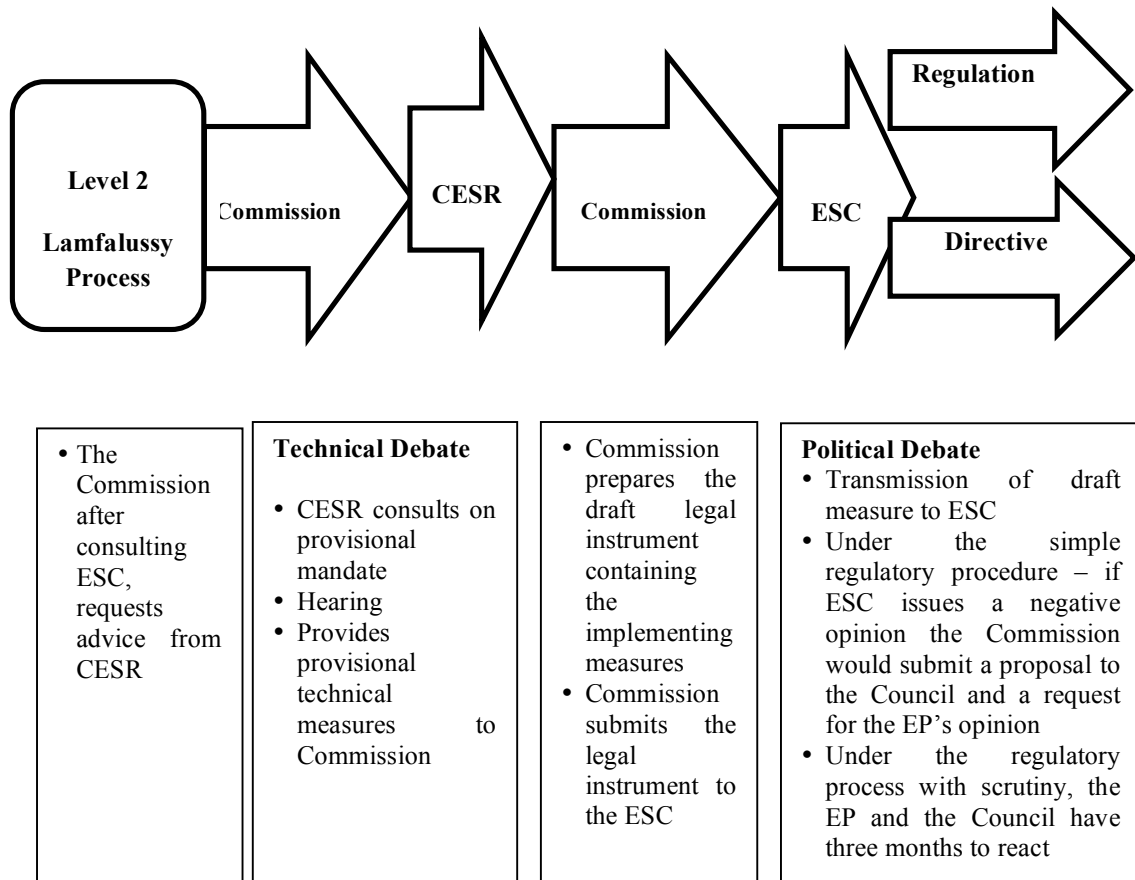
4.3.4 The Structure of the Debate at Level 2 – Pre-Lisbon

At level 2 the Commission adopts Directives or Regulations spelling out implementing measures that have the purpose of supplementing or implementing the essential elements of a piece of legislation set in Level 1 legislation. The Level 1 provisions stipulate the nature and extent of measures permissible at Level 2.⁵³ Limiting the conferred powers to the Commission through specific provisions at Level 1, is another fundamental democratic safeguard which balances the Commission's legislative powers. Matters that should be referred to the Level 2 procedure would, in every case, be agreed to through the co-decision procedure at Level 1. The following diagram explains the structure of the Level 2 debate under the Lamfalussy Process.

⁵² Case-240/90, Federal Republic of Germany v Commission of the European Communities [1992] – Paragraph 37.

⁵³ Moloney (*n19*).

Diagram 4.3 - The Level 2 mechanism (Pre-Lisbon) and which was applied for the purpose of the Level 2 measures under the 2009 UCITS IV Directive.



The structure and degree of institutional coordination and debate at Level 2 is a key element of the Lamfalussy formula. It allowed the law-making process at this level to operate effectively. It is therefore relevant to consider the operation of the governance mechanism at Level 2. This includes an examination of the pre-comitology stage, during which the Commission obtained advice from CESR, and the comitology procedure which resulted in the adoption or rejection of the proposed implementing measure.

Before the Treaty of Lisbon, all Level 2 measures, including those enacted under the 2009 UCITS IV Directive, were adopted under the comitology procedure in terms of article 202 of the TEC⁵⁴ as supplemented by the 1999 Council Decision on

⁵⁴ In terms of Article 202 TEC, the Council had the right to decide that control by the Member States of implementing powers conferred on the Commission was not necessary, in which case the Commission could have adopted implementing measures without the application of a comitology procedure.

Comitology⁵⁵, and the legislative measures which were adopted to bring the Lamfalussy Process into effect, being the 2001 Commission Decision on ESC⁵⁶ and the 2001 Commission Decision on CESR.⁵⁷ On the basis of the powers granted to the Commission at Level 1, a mandate would be issued to CESR to draft the technical details of the implementing measures at Level 2. The involvement of CESR, in connection with the exercise of the implementing powers conferred on the Commission, did not form part of the comitology procedure itself. It was purely limited to an advisory function prior to the comitology procedure. The Commission could well have decided to take a completely different course of action from that recommended in CESR's advice. In such instances, one notices a difference in approach adopted by the Commission during the process before and after the Treaty of Lisbon. When explaining the rationale for the difference between CESR's advice and the Commission's approach, the Commission acted with full transparency and coordination in the case of the former, but has so far failed to give enough space for political debate in the case of the latter.

Practical experience with the workings of the governance mechanism of the Lamfalussy Process at Level 2, points towards a high degree of cooperation between the Commission and CESR at this Level.⁵⁸ To ensure the success of the process, the Commission and CESR established both formal and informal governance mechanisms for cooperation and coordination of the work at Level 2. CESR, in particular, established a number of technical expert groups made up of officials from the national financial supervisors of all Member States, who would be responsible for drafting the Level 2 advice to the Commission. In the field of UCITS in particular, CESR established the investment management expert group.⁵⁹

During the preparation of the advice to the Commission, representatives from the Commission would attend the relevant expert group meetings and would express a view during the discussion. The Commission's presence at the CESR meetings was required

⁵⁵ Decision 1999/468/EC.

⁵⁶ Decision 2001/528/EC .

⁵⁷ Decision 2001/527/EC.

⁵⁸ The author was involved in a number of CESR expert groups which were responsible for the preparation of advice to the Commission at Level 2 of the Lamfalussy Process. Presently, the author is a member of various ESMA standing committees, which have replaced the CESR expert groups.

⁵⁹ CESR, 'Mandate for the Expert Group on Investment Management' CESR/04-160, June 2004. <<http://goo.gl/bvWyNY>>accessed 15.03.14.

in terms of the 2001 Commission Decision on CESR. Moreover, through bilateral meetings and exchanges of letters, CESR would seek to ensure that the position of the Commission would be taken into account and that the advice would be legally sound.

Following the submission of the advice, the Commission would invite CESR for bilateral meetings and discussions in the preparation of the legal text to be proposed as a Level 2 measure, before referral to the ESC. It is submitted that the formal and informal governance mechanisms applied for the purpose of the Level 2 process were equally important in ensuring proper coordination and reveal the importance of flexible governance for the purpose of ensuring an effective legislative process.

The extent of collaboration between the Commission and CESR was formally acknowledged by way of strong public announcements made by both institutions during the ESC meeting held on the 16 December 2009.⁶⁰ The collaboration at Level 2 was a key element of the Lamfalussy formula for an effective law-making process and a ground-breaking development in the governance mechanism for EU regulation as it guaranteed that the process would benefit from the interaction of the European elite in regulation. This debate proved to be critical for the overall success of the entire process and for strengthening mutual trust between the Member States.

Nonetheless, the specific requirement in the 2001 Commission Decision on CESR, requiring an official of the Commission to be present at CESR meetings and to participate in all its debates seems to point towards an attempt by the Commission to monitor, control or even perhaps limit CESR's influence in the Level 2 process. One may argue that while it was critical for the effective operation of the Level 2 process that a high degree of cooperation between the Commission and CESR should be instituted, this specific requirement in the 2001 Commission Decision on CESR suggests that *ab initio* the Commission was not entirely confident about CESR's ability to deliver its function without guidance and supervision from the former. Possibly, it also points to the Commission's apprehension that CESR would have grown into an institution with considerable and unrestrained powers over the regulatory process and the operation of European financial markets.

⁶⁰ Commission, 'Summary record of the 67th Meeting of the European Securities Committee' 16.12.09, Working Document ESC-14-2009<<http://goo.gl/ze42LI>>accessed 15.03.14.

Once the advice on the implementing measures was delivered, the Commission would consider the proposed technical details and draft a legislative proposal for the ESC's consideration. The role of the ESC and the European Institutions would be determined depending on the type of comitology procedure to be applied, which would be decided at Level 1. Before the entry into force of the new Level 2 procedure after Lisbon and the Simple Control Mechanism Procedure for delegated acts, in the case of financial services the comitology procedure would have generally involved either the Simple Regulatory Procedure⁶¹ or the Regulatory Procedure with Scrutiny by the European Parliament and the Council⁶². These are the procedures applied for the purpose of the implementing measures adopted in terms of the 2009 UCITS IV Directive. The Simple Regulatory Procedure is applied to implementing measures, which stipulate standard forms and procedures that implement the requirements of the Directive. The Regulatory Procedure with Scrutiny is used in adopting implementing measures which amend or supplement the Level 1 act with non-essential elements.

The smooth operation of the above-mentioned mechanisms in the context of the 2009 UCITS IV Directive points towards the significance of a sound democratic process based on transparency, cooperation and inclusive debate which guaranteed the legitimacy of a legislative process. It follows that the role of the Member States, the Council and the European Parliament at Level 2, apart from being a control mechanism over the legislative powers of the Commission, was also a means of giving democratic legitimacy to the legislation adopted by the Commission.

⁶¹ Decision 1999/468/EC as amended by Decision 2006/512/EC, Art 5.

⁶² Decision 1999/468/EC as amended by Decision 2006/512/EC, Art 5a.

4.3.5 The Structure of the Debate at Level 2 – Post-Lisbon

At the insistence of the European Parliament, which wanted more institutional balance of power with regard to the monitoring of the delegation of legislative powers to the Commission, the Treaty of Lisbon changed the legal mechanisms for Level 2.⁶³

After the coming into force of the Treaty of Lisbon on the 1st December 2009, the legislative mechanism for Level 2 became subject to articles 290 and 291 of the TFEU, which distinguish between delegated and implementing acts. The said articles of the Treaty distinguish between Level 2 type *quasi*-legislative acts which would be adopted in the form of delegated acts, and those acts that could be regarded as purely Level 2 type executive implementing acts.⁶⁴ These two types of measures are subject to very different sets of governance processes. Implementing acts remained subject to the comitology procedure, while delegated acts were made subject to what may be referred to as the Simple Control Mechanism Procedure of supervision by the European Parliament and Council, thus excluding comitology committees such as ESC.⁶⁵

An examination of the requirements stipulated in the TFEU, the EU inter-institutional communication setting a common understanding on the Simple Control Mechanism Procedure⁶⁶, the post-Lisbon 2011 Regulation on Comitology⁶⁷, and the literature on the application of implementing acts and delegated acts⁶⁸, has allowed the preparation of the following table which analysis the features of these two legislative measures.

⁶³ P Craig, 'Delegated Acts, Implementing Acts and the New Comitology Regulation' (2011) 36(5) European Law Review 671–687.

⁶⁴ Craig (*n*63) 672.

⁶⁵ TFEU - 289-291.

⁶⁶ Council, 'Note from Presidency to Delegations on the Common Understanding – Delegates Acts', Brussels 10.04.11.

⁶⁷ Regulation (EU) 182/2011.

⁶⁸ Commission, 'Implementation of the Treaty of Lisbon - Delegated Acts: Guidelines for the Services of the Commission' (Brussels, 2011); T Christiansen and M Dobbels, 'Non-legislative Rule Making after the Lisbon Treaty: Implementing the New System of Comitology and Delegated Acts' (2013) 19(1) European Law Journal 42-56; and E Vos, '50 Years of European Integration, 45 Years of Comitology' (2009) Maastricht Faculty of Law Working Paper No.3 <<http://ssrn.com/abstract=1345729>> accessed 06.04.13.

Table 4.1 – Features of Implementing Acts and Delegated Acts

Type of Legislative Instrument	Delegated Act	Implementing Act
TFEU	Article 290	Article 291
The Council and the European Parliament at Level 1	Must make a choice concerning the objectives, content, scope and duration of the delegation of power as well as the conditions to which the delegation is subject i.e. the extent to which delegation will be subject to the Simple Control Mechanism Procedure.	Must define the implementing powers conferred on the Commission, by spelling out the: [a] purpose of these powers; [b] the reasons why the Commission's intervention is necessary; [c] whether the comitology procedure will apply and in the affirmative the specific type of procedure.
Legislative Measure Type	Acts that amend or supplement certain non-essential elements of the legislative act.	Rules establishing uniform conditions for implementing basic acts.
Scope	Only measures of general application, being measures that delete, replace or add non-essential elements or new non-essential rules, which expand the legislative framework of the basic act.	Measures intended solely to give effect to existing rules in the basic act, without adding new elements to the act, or to implement aspects already clearly defined by the legislature.
Conditions to the Legislative Procedure	<p>Council and European Parliament may impose any one of the following:</p> <ul style="list-style-type: none"> • Right to revoke the delegation; • Right to express objections to the delegated act within the period set by the legislative act. <p>The legislative process is subject to the Simple Control Mechanism Procedure as per the EU Inter-institutional common understanding.</p>	<p>New Comitology Procedure</p> <p>Council and European Parliament may impose controls on the basis of the new comitology procedures (advisory and examination).</p>

The above analysis brings out the key distinction between a delegated act and an implementing act. The distinction mainly relates as to whether the legislative measure intended to be adopted at Level 2, was during the debate at Level 1 considered as

amending or supplementing the rules in the Level 1 act or simply giving effect to existing rules without actually adding any additional elements to those rules.⁶⁹ That is:

... whether there is simply a need to adopt the acts to give effect to the rules set by the legislator or whether it is necessary that the Commission has the power to change (amend) or add (supplement) some of the rules of the legislation that are of a non-essential nature.⁷⁰

The Commission argues that the articles are mutually exclusive and do not overlap.⁷¹ This notwithstanding, in certain instances, a measure may easily fall within the parameters of any one of the two different types of acts. Situations may arise where there might be scant reasons why the supplementation of the legislative act in the one instance should be regarded as a new non-essential element such that a delegated act is required, while in a similar circumstance this might not be so, and therefore an implementing act is sufficient.⁷² It is ultimately at the discretion of the legislator to decide on what is essential or not. There are limitations to this. Yet it is ultimately a political decision to determine whether aspects of the financial regulation are essential or otherwise. The distinction is however crucial as it determines the type of governance mechanism to be applied for the purpose of adopting the specific Level 2 measure and the extent of political debate on the proposed measures that should be allowed in this connection.

The EU inter-institutional common understanding, which is a non-legally binding soft-law mechanism, sets the conditions for the application of the Simple Control Mechanism Procedure, by stipulating the procedure to be applied by the institutions for the adoption of delegated acts. This lays down an agreed maximum period of two months (extendable by another two months) for objection by the European Parliament and Council to a proposed delegated act. It also details the standard clauses, which should be included in legislative acts when delegating to the Commission the right to

⁶⁹ Craig (*n63*) 673.

⁷⁰ Christensen and others (*n68*) 44.

⁷¹ Commission, 'Communication from the Commission to the European Parliament and the Council: Implementation of Article 290 of the Treaty on the Functioning of the European Union' COM(2009)673 Final, Brussels, 9.12.2009<<http://goo.gl/V6dbT7>>accessed 15.03.14.

⁷² Craig (*n63*) 673. See also Christensen and others (*n68*).

issue delegated acts.

The Simple Control Mechanism Procedure does not cater for the formal debate within a comitology committee such as the ESC. This significantly diminishes the opportunities of a political type debate on the Level 2 measures. Such a debate is an important element of the Lamfalussy formula for an effective law-making mechanism. A qualified majority in Council or an absolute majority in the European Parliament against the delegated act is required to bring the process to a halt. If the delegated act is drawn to a halt the whole process relating to the delegated act would have to restart *ab initio*. This could create difficulties as, more often than not, the delegated acts are required for the Level 1 to become operative and workable. Such a process renders a possible vote against the delegated act in Council highly improbable, although not impossible. This in fact significantly strengthens the power of the Commission.

The post-Lisbon 2011 Regulation on Comitology sets the mechanism for the adoption of implementing acts. One may argue that the Regulation, like the 1999 Decision on Comitology, creates a *supra*-legislative governance mechanism as the European Parliament and the Council are subjected to the mechanism set in the Regulation when exercising their legislative powers at Level 1. Consequently, only those governance mechanisms for control that are established by the Regulation may be applied by the legislature when delegating powers to the Commission.

The post-Lisbon 2011 Regulation on Comitology explains the concept of implementation for the purposes of Article 291 of the TFEU as comprising both the drawing up of implementing rules in the form of acts of general scope and the application of rules to specific cases by means of acts of individual application. In the context of the Lamfalussy Process, an example of an implementing power that a Level 1 Act may confer on the Commission in terms of article 291 of the TFEU, is that of defining the format or content of a report or a notification, which the industry is required to submit in terms of Level 1. At Level 2 of the Lamfalussy Process, the role of the ESC as comitology committee has been retained.⁷³

⁷³ Regulation (EU) 182/2011, article 3.

The significance of the post-Lisbon Level 2 mechanism of the Lamfalussy Process within the context of UCITS is the amendment to the 2009 UCITS IV Directive by the 2010 Omnibus Directive.⁷⁴ The latter Directive *inter alia* had the purpose of making the changes to the 2009 UCITS IV Directive for the purpose of giving effect to the framework provided in the TFEU and to establish the powers of ESMA to issue binding technical standards. It replaced the implementing powers designed under article 202 of the EC Treaty with the appropriate provisions of articles 290 and 291 TFEU. The changes to the 2009 UCITS IV Directive considerably relate to the introduction of powers to issue delegated acts. More delegated acts will also be required once the 2012 UCITS V Proposal⁷⁵ is adopted.

For the purpose of the analysis it is relevant to compare the operation of the Level 2 process in practice before and after the post-Lisbon changes to the 2009 UCITS IV Directive. As all the implementing measures under the 2009 UCITS IV Directive were adopted before the post-Lisbon changes to the Directive, it is relevant, for comparative purposes, to refer to the experience relating to the preparation and debate on the Commission's AIFMD Delegated Act⁷⁶, which was adopted earlier on this year.

4.3.6 The Outcome of the Debate at Level 2 – Pre and Post Lisbon

Practical experience regarding the functioning of the Level 2 governance mechanism suggests that while the preparation of the advice by CESR, and now ESMA, is generally an exercise of deliberation by technical experts in which good arguments matter more than economic interest and formal voting rules⁷⁷, the ESC is an arena for political debate and intergovernmental bargaining designed by Member States to control the Commission.⁷⁸

⁷⁴ Directive 2010/78/EU.

⁷⁵ Commission, 'Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to UCITS as regards depositary functions, remuneration policies and sanctions', Brussels 3 July 2012. <<http://goo.gl/bvWJxi>>accessed 16.03.14.

⁷⁶ Delegated Regulation (EU) No231/2013.

⁷⁷ See above (n58).

⁷⁸ N Moloney, 'New Frontiers in EC Capital Markets Law: From Market Construction to Market Regulation' (2003) 40 Common Market Law Review 809-843.

The ESC is made up of officials from the Ministries of Finance of the Member States, who are guided and monitored by their financial attachés in Brussels. The same approach used in Council is adopted for the purpose of ESC meetings. The different levels of debate within CESR, and now ESMA, and at the level of the ESC, are critical for the strengthening of mutual trust between the Member States as it allows the opportunity to raise both technical and political considerations which emerge from specific measures, that have an impact on the conduct of business by the industry. A case in point is the Level 2 process as applied to the 2009 UCITS IV Directive.

In the context of the 2009 UCITS IV Directive, the Commission's draft implementing measures, which were presented to the ESC, reproduced to a large extent CESR's advice, which was the outcome of extensive debate and consultation with stakeholders. Adjustments made by the Commission to CESR's advice in the draft implementing measures were reflected in a transparent manner through comparative tables, which the Commission provided to the Member States and the European Parliament.⁷⁹ These tables bear out the Commission's efforts to realise an efficient process at Level 2.

The ESC process on the Level 2 measures commenced on the 16 December 2009. The minutes of the ESC meeting held on this date, and those of the subsequent ESC meetings held on the 5 February 2010, 8 March 2010 and 12 April 2010⁸⁰ put on record a high degree of discussion and cooperation between the Commission, the Member States and the European Parliament, aimed at achieving a high degree of efficiency. It is interesting to note that CESR also participated in this process.

The minutes of the ESC meetings specify that draft implementing measures were discussed at length during the meetings, informally with individual Member States and the European Parliament and also by way of various written comments. This process allowed the Commission to gather detailed information on the various considerations on its draft implementing measures and eventually to make the necessary changes, which would allow a positive outcome at ESC. In the end, this permitted a fast and smooth process with final approval of the proposed implementing measures at ESC level

⁷⁹ Commission, 'Summary record of the 67th Meeting of the ESC' 16.12.09, Working Document ESC-14-2009.

⁸⁰ The minutes of the relevant ESC meetings are available <<http://goo.gl/Eovsdl>>accessed 16.04.13.

subsequent to significant political debate that took place over a period of less than four months.

The efficiency of the Level 2 process as it was operated in the context of the 2009 UCITS IV Directive, confirms the significance of both the technical and political aspect of the debate on proposed financial regulation and the importance of cooperation and proper transparency in the process. This contrasts with the way in which the process at Level 2 operated with regards to the adoption of the AIFMD delegated regulation⁸¹ where the political level of one of these two distinct levels of debate was not formalised. Practical experience in the operation of the Simple Control Mechanism Procedure has shown that where Member States are not given the opportunity to formally discuss their concerns about the proposed measures, the governance mechanism for law-making turns into an environment of unstructured and tense inter-institutional dialogue.⁸² In the end, this could have an impact on the quality of the substantive regulation which is finally adopted.

During the legislative process of the AIFMD Delegated Act, the Commission deviated from the ESMA's advice without proper explanations. As the proposal was for the issue of a delegated act and therefore subject to the Simple Control Mechanism Procedure, no formal discussion on the political considerations that emerge from the content of the delegated regulation took place during the legislative process. Furthermore, no formal transparency mechanism was applied by the Commission, with different versions of the proposal being leaked to stakeholders⁸³, causing uncertainty about the rationale for the Commission's change in position. This state of affairs generated a process of vague inter-institutional dialogue and heavy industry lobbying⁸⁴, which resulted in a formal complaint by 12 Member States to the Commission, regarding the functioning of the Simple Control Mechanism Procedure.

⁸¹ Delegated Regulation (EU) No231/2013.

⁸² (n58).

⁸³ Clifford Chance, 'AIFMD Level 2 Regulation Final Text Released' <www.cliffordchance.com>accessed 01.05.13.

⁸⁴ See references to the extensive industry lobbying on the draft AIFMD Delegated Act in the following amongst others: BNY Mellon, 'AIFMD and the Impact on Investment Trusts' June 2012 <www.bnymellon.com>; Deloitte, 'AIFMD: Where are we in the process?' 2012 <www.deloitte.com>accessed 01.05.13.

The complaint emphasised the following two weaknesses:

Firstly, the Commission's draft Delegated Act for the AIFMD Regulation departs from ESMA's advice in a number of areas, without explanation. ESMA advice is compiled through a transparent and thorough consultation process, and provides expert understanding from Europe's supervisory authorities.

Secondly, while we recognise the Commission is not obliged to follow ESMA advice, the credibility of the process of producing delegated acts must be ensured. One avenue forward would be to openly consult the Member States. We therefore urge the Commission to adopt a more open and consultative approach in future, when drawing up delegated acts.⁸⁵

The Member States' formal complaint was a warning shot to the Commission, that the governance mechanism for Level 2 delegated acts was resulting to be ineffective and had to be changed. The outcome of the legislative process highlighted the inherent weaknesses of the Simple Control Mechanism Procedure mentioned in the Member States' formal complaint. Certain aspects of the Commission's AIFMD Delegated Act, such as the requirements which prohibit management companies from being set up as letter box entities, are vague and leave much room for interpretation by Member States.

One may argue that the Commission itself was not comfortable with the outcome of the process as it included a provision which encouraged ESMA to issue Level 3 Guidance for the consistent implementation of the requirements on letter box entities.⁸⁶ It also included a clause which requires the Commission to review the operation of the requirements in practice within two years from the date of the coming into force of the Commission AIFMD Regulation. The short period of time within which the Commission is required to carry out the review, is in itself indicative of the extent to which the Commission was not convinced about the resulting legislation.

⁸⁵ Council, Statement by Finland, Denmark, Czech Republic, Latvia, Sweden, Ireland, Netherlands, United Kingdom, Germany, Austria, Luxembourg and Portugal on Commission Delegated Regulation of 19.12.12 supplementing Directive 2011/61/EU, Inter-institutional file: 2009/0064(COD) 26.02.13.

⁸⁶ Delegated Regulation (EU) 231/2013, article 82.

4.3.7 Specific Conclusions on Level 1 and 2

The analysis supports the validity of the Lamfalussy formula for financial regulation based on the following elements: transparency and consultation with stakeholders; inclusive technical and political debate; and inter-institutional cooperation. These elements complement each other and are cardinal pillars of the whole structure. The analysis suggests that unless all the elements are allowed to operate effectively, the legislative process will lose on its efficiency, particularly because these elements have a role in strengthening mutual trust between Member States, which is a critical condition for effective mutual recognition.

The extent of debate at all stages of Level 1 and 2 of the 2009 UCITS IV Directive contributed to the realisation of *quasi*-maximum harmonisation more rapidly. From the date of publication of the Commission's proposal for a UCITS IV Directive on the 16 July 2008, it took the Council and the European Parliament less than 6 months to approve, in identical terms, a compromise text of the proposal for a UCITS IV Directive, with the final version of the Directive being adopted by co-decision within less than a year, on the 22 June 2009.⁸⁷ This is exceptional speed when compared with the way the legislative process operated before the adoption of the Lamfalussy Process.

The momentum was also kept with regards to the Level 2 process with the ESC voting in favour of the implementing measures on the 12 April 2010, which is less than six months from the date of the submission of CESR's advice to the Commission. It compares favourably with the twelve odd months which the Commission took to adopt the AIFMD Delegated Act. In terms of the degree of harmonisation of financial regulation, at the end of the process the UCITS Directive had been transformed into a Directive which harmonises the financial regulation of more fields of activity in the area of investment management and which was supplemented by two implementing Directives⁸⁸ and two implementing Regulations⁸⁹.

⁸⁷ Commission's web-site UCITS Directive < <http://goo.gl/anOykw> > accessed 14.04.13.

⁸⁸ Directive 2010/42/EU; and Directive 2010/43.

⁸⁹ Regulation (EU) No583/2010; and Regulation (EU) No584/2010.

The success of the Lamfalussy Process at Level 1 and 2 as applied to the 2009 UCITS IV Directive, was due to the fact that it was transparent and promoted a wide inclusive debate that allowed for both technical and political concerns to be made at all levels. The reaction of Member States to the outcome of the legislative process which led to the adoption of the Commission AIFMD Delegated Act, has shown in no uncertain terms that inter-institutional tensions could result and have a bearing on the effectiveness of the legislative process, when one or several elements of the Lamfalussy formula is not allowed to operate properly. On this basis one may venture to recommend that the procedure for delegated acts should be reconsidered if the Level 2 of the Lamfalussy Process is to remain efficient.

4.4 Level 3: An Open Method of Coordination for Convergence and the Governance of European Supervision

It is reasonable to suggest that a commitment to a uniform approach to the implementation and/or interpretation of financial regulation is the ultimate test for the internal market. Uneven implementation and/or different interpretation, frustrate harmonisation effort, which is a necessary condition for effective mutual recognition. The open method of coordination at Level 3 of the Lamfalussy Process sought to achieve a certain degree of consistency in the implementation and interpretation of European financial regulation by national financial supervisors.

To fulfil the objectives at Level 3, the CESR standing committees, in addition to being involved in the preparation of Level 2 advice to the Commission, also had the role of producing standards, guidelines and recommendations (henceforth referred together as ‘Level 3 Guidance’) which deal with the implementation of Level 1 and 2 financial regulation. Level 3 Guidance had to be compatible with Level 1 and 2. However, at Level 3 CESR played a role that was independent from the EU Institutions and extended to the issue of guidance that set common standards regarding matters that were not covered by EU legislation and where a certain degree of uniformity was deemed necessary.

The use of the open method of coordination within the framework of the Lamfalussy Process aimed at achieving speed and flexibility, which was critical if the legislative

process was to keep up with developments in financial markets. It also offered a focal point for convergence.⁹⁰ In financial markets, even more than in other fields of law, regulation has to be in a position to adapt and respond to market developments in order to mitigate uncertainty and restore market confidence.⁹¹ Level 3 promoted harmonisation without the political compromises at Level 1 and possibly also at Level 2. Concurrently, however, it allowed the national financial supervisors to take political considerations into account during the implementation stage of the specific Level 3 Guidance.

The application of the open method of coordination at Level 3 of the Lamfalussy Process was an acknowledgement that the rapidity of innovation and technological development in financial markets could undermine financial regulation which was difficult to change. Consequently, it was realised that part of the regulatory tools for EU financial regulation itself had to be flexible enough to be easily adaptable in the light of changing financial market conditions. CESR made extensive use of Level 3 Guidance for this purpose.⁹²

In theory, it has been argued that CESR Level 3 Guidance had a binding effect beyond their *de facto* normative character, since a presumption of correctness prevailed unless proper justifications for non-compliance were presented.⁹³ In practice, however, under the CESR regulatory framework no such requisite existed. Level 3 Guidance was implemented strictly on a voluntary basis, with CESR Members exercising *peer pressure* on each other to apply it. However, at Level 3, CESR was unable to ensure that guidance was adopted in a harmonised way in all Member States. As a consequence, this legislative method has in certain instances failed to achieve a sufficient degree of harmonisation.⁹⁴ Such situations are harmful to mutual recognition.

⁹⁰ E Ferran and K Alexander, 'Can soft law bodies be effective?' (2010) 35(6) *European Law Review* 751-776.

⁹¹ C Milhaupt and K Pistor, *Law and Capitalism: What Corporate Crisis Reveal About Legal Systems and Economic Development Around the World* (University of Chicago 2010).

⁹² D Vitkova, 'Level 3 of the Lamfalussy process: an effective tool for achieving pan-European regulatory consistency?' (2008) 2(2) *Law and Financial Markets Review* 158-174.

⁹³ T Mollers, 'Sources of Law in European Securities Regulation – Effective Regulation, Soft Law and Legal Taxonomy from Lamfalussy to de Larosiere' (2010) 11(3) *European Business Law Review* 381-407.

⁹⁴ S Chaher, 'Is Lamfalussy falling from the third floor (level)?' (2005) Research Paper London School of Economics and Political Science <www.ssrn.com> accessed 22.07.11.

CESR's competence fell short of being in a position to adopt binding rules or else impose binding decision on national financial supervisors.⁹⁵ The fact that CESR's Level 3 Guidance was not formally binding meant that the guidance was visibly weak in comparison to hard-law enacted through Level 1 and Level 2 legislation. However, this very weakness allowed CESR to intervene in areas, such as clearing and settlement, which were not formalised in EU law as, at the time, a political consensus seemed to be practically impossible.⁹⁶ While, prior to the financial crisis, Member States were not willing to legislate in this area, national financial supervisors were willing to co-ordinate their policies. In the aftermath of the crisis, this co-ordination reaped its most significant benefit as it formed the basis for a Level 1 and 2 regulatory initiative in this field. One can point towards this development as one of the concrete benefits which were derived out of the open method of coordination which resulted in CESR Level 3 Guidance.

Nonetheless, the fact remains that in general national financial supervisors did not implement Level 3 Guidance properly. By way of example, when CESR assessed the extent of implementation by national financial supervisors of its 'Guidelines to Simplify the Notification Procedure of UCITS'⁹⁷, which had the purpose of overcoming the uncertainties which existed with regards to the passporting under the 1985 UCITS Directive, only five out of twenty-nine national financial supervisors were found to be fully compliant with these guidelines, while only another four were found to be partially compliant.⁹⁸ The poor level of compliance by national financial supervisors with the Level 3 Guidance on passporting of UCITS is indicative of a process which might not have been all-inclusive and where national financial supervisors might have felt that they did not own the solution proposed by CESR for further integration. It also meant that the benefits that could have been derived from the application of a simplified notification procedure based on soft-law were limited as an additional layer of regulatory fragmentation within the EU had been created. While Level 3 Guidance was

⁹⁵ E Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision' (2011) University of Cambridge Research Paper 29/2011 <www.ssrn.com> accessed 04.08.11.

⁹⁶ CESR and ECB, 'Standards for Securities Clearing and Settlement in the European Union' September 2004 <<http://goo.gl/7Z3KDX>> accessed 15.03.14.

⁹⁷ CESR, 'CESR guidelines to simplify the notification procedure UCITS' CESR 06-120b, June 2006 <www.esma.europa.eu> accessed 15.03.14.

⁹⁸ CESR, 'Press Release: CESR Review the application of guidelines to simplify the notification procedures of UCITS across Europe' CESR/10-016, 29.01.10 <<http://goo.gl/bvWyNY>> accessed 15.03.14.

easy to adopt, it was clearly difficult to enforce.

As part of the 2009 UCITS IV Directive, CESR produced eight sets of Level 3 Guidance, promoting regulatory convergence in different areas, which are regulated by the Directive. This process included a regulatory framework for money market funds, the failures of which during the financial crisis became a regulatory concern for policy-makers. MMFs have been in the spotlight since the September 2008 collapse of the \$62.5 billion Reserve Primary Fund in the US. Given the damage, which the failure of the Reserve Primary Fund had on the financial system, CESR decided to improve the coordination of regulation through Level 3 Guidance, by setting standards on the definition of MMF and the methods for the calculation of the prices of MMFs.⁹⁹

Yet again, not all national financial supervisors implemented the Level 3 Guidance on MMFs. A review carried out by ESMA for the purpose of determining the level of compliance with the Level 3 Guidance on MMFs, noted that ten national financial supervisors had not taken the necessary measures to implement this Level 3 measure.¹⁰⁰ Moreover, this created incentives for the national financial supervisor of a Member State, which had implemented the Level 3 MMF Guidance, to challenge the passporting of a UCITS that is designated as MMF in a Member State where the national financial supervisor had failed to implement the Level 3 Guidance, as evidently such UCITS would afford a lower degree of investor protection. This is yet another example of the fragmentation resulting from the adoption of non-binding measures by CESR at Level 3.

Therefore, while soft-law gives a certain degree of flexibility, it may lead to legal uncertainty that may endanger part of the harmonisation process. This, in turn, damages the mutual recognition between the Member States. The lack of compliance by national financial supervisors with CESR's Level 3 Guidance points towards the need for a somewhat harder legal approach. It follows that unless soft-law mechanisms, such as Level 3 Guidance, are complemented by mechanisms for enforcement, such as a comply or explain framework, it is doubtful whether soft-law mechanisms may operate

⁹⁹ CESR, 'Guidelines on a Common Definition of European MMFs' CESR-10/049<<http://goo.gl/bvWyNY>>accessed 15.03.14.

¹⁰⁰ ESMA, 'Peer Review – MMF Guidelines' ESMA/2013/476, 15.04.13<<http://goo.gl/lSbWcl>> accessed 15.03.14.

effectively to strengthen mutual recognition between Member States. Indeed, they may have the opposite effect, as they may be the cause of an additional layer of fragmentation.

Under the taxonomy set for the purpose of this thesis, the lack of enforceability of the Level 3 Guidance for regulatory convergence under the CESR framework may be classified as a limitation of the governance mechanism for mutual recognition. This limitation was recognised by the Commission in 2007 when it expressed concern that Level 3 Guidance had not been applied consistently by national financial supervisors.¹⁰¹ Another limitation relates to the fact that CESR's efforts at this level were mainly focused on measures to achieve regulatory convergence with little or no efforts in the field of supervisory convergence. Throughout the existence of CESR, financial supervision in the EU remained largely fragmented with different models applied in the different Member States.

Nonetheless, the pooling of knowledge between national financial supervisors within CESR was beneficial for cooperation, particularly for those national financial supervisors established in Member States which have unsophisticated or undeveloped financial markets. Practical experience in financial supervision suggests that such national financial supervisors, at times, proved not to have the resources or technical expertise to resolve technical difficulties in day-to-day supervision properly, without the guidance that could be afforded by other more sophisticated authorities.¹⁰² In this sense, CESR was a mechanism for reflexive governance as it provided the venue that sought to create an environment of debate, mutual learning, the sharing of knowledge and cooperation in supervisory matters.

To resolve part of the internal market concerns that emerged from the financial crisis, the DeLarosiére Report *inter alia* proposed the establishment of a European System of Financial Supervisors, including the creation of ESMA which would replace CESR.¹⁰³

¹⁰¹ Commission, 'Review of the Lamfalussy Process—Strengthening Convergence' COM(2007)727 6<<http://goo.gl/qvfuJb>>accessed 15.03.14.

¹⁰² (n58).

¹⁰³ Commission, 'Proposal for a Regulation Establishing a European Securities and Markets Authority' COM(2009)53 23.09.09<<http://goo.gl/sudz92>>accessed 15.03.14 and N Moloney, 'Reform or revolution? The financial crisis, EU financial markets law, and ESMA' (2011) 60(2) *International and Comparative Law Quarterly* 521–533.

ESMA, which under the EU institutional framework has the status of an agency¹⁰⁴, has various objectives which it is bound to achieve. These include improvement in the functioning of the internal market, the protection of public values such as the integrity and stability of the financial system, the transparency of markets and financial products and the protection of investors.¹⁰⁵ ESMA has also been given the tasks of preventing regulatory arbitrage, guaranteeing a level playing field and promoting supervisory convergence.¹⁰⁶

From a Lamfalussy Process point of view, ESMA's role is of more significance than that of CESR. In addition to its role as advisor to the Commission at Level 2, ESMA¹⁰⁷ has the higher role of being a *de facto* European Authority with *quasi*-regulatory powers in the field of securities business. It has the authority to establish binding technical standards¹⁰⁸, and has supervisory powers limited to the monitoring of credit ratings agencies and trade repositories. It also has the ability to prohibit or restrict financial activities that threaten the orderly functioning and integrity of financial markets.¹⁰⁹

Technical standards, which create another layer of Level 2 type financial regulation, are drafted by ESMA but must be endorsed by the Commission to become law and take the form of either delegated acts or implementing acts.¹¹⁰ There is a general ruling in EU Law that prohibits the delegation to agencies, such as ESMA, of general regulatory powers that the Treaty confers on the EU Institutions. The ruling was set by the

¹⁰⁴ The Treaty does not define the meaning of an 'agency' however this is understood by the Commission as 'an independent legal entity created by the legislator in order to help regulate a particular sector at European level and help implement a particular Community policy' - Commission, 'Draft Inter-institutional Agreement on the operating framework for the European regulatory agencies' 22.02.05 COM(2005)59 Final.

¹⁰⁵ Regulation (EU) No1095/2010, recital 11.

¹⁰⁶ Regulation (EU) No1095/2010, recital 11.

¹⁰⁷ For a summary of the ESMA Framework with commentary see C Reynolds, 'Uncharted waters? The changing European financial regulatory framework' (2010) 25(11) *Journal of International Banking and Financial Law*; and P Snowden and S Lovegrove, 'The new European supervisory structure' (2011) *Compliance Officer Bulletin* 1-39. For a critical analysis of ESMA, see: N Moloney, 'The European Securities and Markets Authority and institutional design for the EU financial market – a tale of two competences: Part 1 and Part 2 (2011) 12(1)/(2) *European Business Organization Law Review* 41–86 and 177–225; E Wymeersch, 'Europe's New Financial Regulatory Bodies', (2011) 11 *Journal of Corporate Law Studies* 433–462; and P Weisemann, 'The European Financial Market Supervisory Authorities and Their Powers to Issue Binding Rules' (2012) 27(12) *Journal of International Banking Law and Regulation* 495–500.

¹⁰⁸ Regulation (EU)1095/2010, articles 10–15.

¹⁰⁹ Regulation (EU)1095/2010, article 9.

¹¹⁰ M Busuioc, 'Rule-Making by the European Financial Supervisory Authorities: Walking a Tight Rope' (2013) 19(1) *European Law Journal* 111-125

European Court of Justice in the 1958 *Meroni* case.¹¹¹ In the course of that judgment, the Court laid down what have become well-established principles on delegation of regulatory powers to regulatory agencies, which have been the subject of considerable academic and policy debate.¹¹²

In *Meroni* the ECJ distinguished between delegation of clearly defined executive powers the application of which can be subject to review on the basis of objective criteria decided by the delegating authority, and delegation of discretionary powers.¹¹³ In terms of *Meroni* the latter is not permitted, as the delegation of discretionary powers would make the balance of powers that is a fundamental guarantee granted by the Treaty unproductive, since such delegation would substitute the choices of the delegator with those of the delegate and cause a shift of responsibility.¹¹⁴ For that reason, such restriction in the possibilities to delegate powers may be explained in the light of the principle of balance of powers, which *Meroni* recognized for the first time in the Community legal order.¹¹⁵ Hence, *Meroni* means that an agency may not be delegated tasks under conditions that would deprive the institutions of the Union of the competences vested upon them by the EU Treaties, since this would be contrary to the principles of institutional balance and of conferral of powers to the institutions, as enshrined in the Treaties.

Consequently, agencies may only be assigned powers that are limited to the taking of individual decisions in specific areas where defined technical expertise is required, under clearly and precisely defined conditions and without genuine discretionary power.¹¹⁶ In this regard, an agency may be granted the powers to adopt legally binding measures as long as its powers are not discretionary in that the implementation of those

¹¹¹ Case 9/56 *Meroni & Co., Industrie Metallurgische S.p.A v High Authority* [1957 & 1958] ECR 133.

¹¹² S Griller and A Orator, 'Everything under control? The 'way forward' for European agencies in the footsteps of the *Meroni* doctrine' (2010) 35(1) *European Law Review* 3-35; E Chiti, 'An important part of the EU's institutional machinery: Features, problems and perspectives of European agencies' (2009) 46 *Common Market Law Review* 1420-4; M Chamon, 'EU Agencies between *Meroni* and *Romano* or the Devil and the Deep Blue Sea' (2011) 48(4) *Common Market Law Review* 1055-1075; and K Lenaerts, 'Regulating the regulatory process: Delegation of powers in European Community' (1993) 18(1) *European Law Review* 23-49.

¹¹³ T Tridimas, 'Community Agencies, Competition Law and ECB Initiatives on Securities Settlement' (2009) 28(1) *Yearbook of European Law* 216-307.

¹¹⁴ Tridimas (*n*113).

¹¹⁵ Chiti (*n*112) 1421.

¹¹⁶ Commission, 'Communication to the European Parliament and the Council: European Agencies: The Way Forward', COM(2008)135, 11.03.08<<http://goo.gl/fFriZ8>>accessed 10.02.14.

powers must result from the application of an existing set of legal rules to a particular factual situation. In line with *Meroni* ESMA cannot be entrusted with powers which may affect the responsibilities that the Treaty has explicitly conferred on the Commission.¹¹⁷ In practice this means that ESMA may only prepare technical standards where this is specifically prescribed in primary Acts and such standards become law only when endorsed by the Commission.¹¹⁸ This position is not comparable to the rule-making powers of the SEC in the US, where the SEC is the one that adopts the rules.¹¹⁹

Technical standards take the legislative form of either Regulations or Decisions. This means that they would be directly applicable to Member States, national financial supervisors and financial institutions. The scope of technical standards is limited to technical issues that contribute significantly and effectively to the achievement of the objectives of the relevant legislation but cannot involve the taking of policy decisions that fall within the competence of the European Parliament, the Council and the Commission in accordance with the applicable procedure.¹²⁰ The various safeguards made on the adoption of technical standards by ESMA, seem an attempt at reconciling the essential flows from representative democracy and constitutionalism with the need to engage with expert knowledge in the highly technical world of financial markets.

Nonetheless, in a dynamic financial system dominated by cross-border financial institutions of a significant size, restricting the discretion of a financial supervisor is not compatible with the needs of regulation and supervision which must be capable of quick adaptation to rapidly changing circumstances. In this connection, doubts have been expressed on whether the principle of institutional balance really excludes the setting up of agencies provided with powers involving a real margin of discretion.¹²¹ Indeed, it is questionable whether the requirement that the general balance of the institutions established by the Treaty should not be altered, actually implies that European agencies must be granted non-discretionary powers.¹²² Furthermore, the view has been put

¹¹⁷ Chiti (*n112*) 1422.

¹¹⁸ T Tridimas, 'EU Financial Regulation: Federalization, Crisis Management, and Law Reform' in *The Evolution of EU Law* (Oxford 2011) 802.

¹¹⁹ R Lastra, 'The Governance Structure of Financial Regulation and Supervision in Europe' (2003) 10 *Columbia Journal of European Law* 49-68.

¹²⁰ Directive 2010/78/EU, recital 11.

¹²¹ Chamon (*n112*) 1058.

¹²² Chiti (*n112*) 1424.

forward that to understand the reasoning of the Court in *Meroni* it is relevant to consider the meaning of balance of powers at the time of the *Meroni* ruling itself.

The point has been made that the principle of balance of power was originally formulated as a replacement for Montesquieu's philosophy on separation of powers, the aim of which was to protect members of society from the abuse of power.¹²³ In conformity with this view, by referring to the balance of powers the Court did not express a concern about the effect on inter-institutional relations, but a concern regarding the Treaty's system of judicial protection. It has been argued that given the original meaning of the principle of balance of powers it would appear more suitable to stress the importance of a system of effective judicial protection when referring to the *Meroni* judgement, than it is to emphasize the institutional balance.¹²⁴

Furthermore, it has been opined that *Meroni* should not be treated as an unmovable signpost and should be viewed within the context of the development of EU constitutional law and Treaty guarantees.¹²⁵ Before Lisbon there was no reference in the Treaty to the possibility to grant agencies with specific tasks and powers. The Treaty of Lisbon altered this as articles 263 and 277 TFEU provide that the CJEU can review the legality of acts of agencies such as ESMA. Therefore, the fact that the Treaty foresees legal redress against acts of such agencies would appear to recognize that the agencies may be granted decision-making powers and militates towards a less strict interpretation of *Meroni*.

A recent opinion by Jääskinen AG on the powers granted to ESMA in terms of the Short Selling Regulation¹²⁶, and the decision of the CJEU on the same case ('ESMA Ruling'), expressed the view that the Treaty of Lisbon has addressed the pivotal concerns with which the Court had to deal in *Meroni*; namely the absence of Treaty based criteria for the conferral and delegation of powers so as to ensure respect for institutional balance and the vacuum in terms of judicial review of legal binding acts of

¹²³ J Jacqué, 'The Principle of Institutional Balance' (2004) 41(2) Common Market Law Review 384.

¹²⁴ Chamon (*n112*) 1059.

¹²⁵ Tridimas (*n113*) 245.

¹²⁶ Regulation (EU) No236/2012.

agencies.¹²⁷ Therefore, it is reasonable to argue in favour of a less strict interpretation of the *Meroni* principles and for agencies such as ESMA to be granted greater scope of manoeuvring. It follows that where delegation is restrained by the legal guarantees provided in the existing Treaty, no unsafe transfer of responsibility would arise.¹²⁸ This is a critical development in the understanding of *Meroni* if the powers of ESMA are to be reinforced.

While the regulatory and supervisory powers granted to ESMA are considerable when compared to CESR, however one may still argue that more discretion is required if ESMA is to be in a position to fulfill more completely its objective of improving the functioning of the internal market. Discretionary powers to regulate and supervise are ultimately important and justified on the basis that the financial system and the problems that may develop within such a system are increasingly sophisticated and require wide scope for manoeuvring if they are to be addressed properly. On this basis more centralisation may be an adequate alternative to convergence of national supervision. This is the solution applied with regard to the supervision of banks in the Euro-Zone, which fall under the responsibility of the ECB within the framework of a single supervisory mechanism.¹²⁹ Albeit, the possible centralization of one function does not imply nor require the centralization of all supervisory functions.¹³⁰ Indeed, the US experience in securities regulation suggests that Federal and State supervision may co-exist and that a flexible application of the delegation doctrine does not conflict with the institutional balance between the branches of government, but can strengthen such balance by permitting these branches to focus on their core area of regulation.¹³¹

In the US the delegation doctrine, according to which some legislative powers can be entrusted to agencies, has not generally been taken as a threat to the balance of powers

¹²⁷ Opinion of the Advocate General Jääskinen delivered on 12 September 2013 C-270/12 United Kingdom of Great Britain and Northern Ireland v Council of the European Union and European Parliament; and Judgment of the Court (Grande Chamber) delivered 22 January 2014 in case C-270/12.

¹²⁸ J Pelkams and M Simoncini, 'Mellowing Meroni: How ESMA can help build the single market' (2014) CEPS Commentary <<http://goo.gl/8lQkSu>> accessed 22.02.14.

¹²⁹ Regulation (EU) No 1024/2013.

¹³⁰ Lastra (*n119*).

¹³¹ D Geradin, 'The Development of European Regulatory Agencies: What the EU should Learn from American Experience' (2005) 11 Columbia Journal of European Law.

between the branches of Government.¹³² On the contrary the US Supreme Court declared that:

‘our jurisprudence has been driven by a practical understanding that in our increasingly complex society, replete with ever changing and more technical problems, Congress simply cannot do its job absent an ability to delegate power under broad general directives.’¹³³

On the other hand, in the EU the limitations on delegation which have so far been imposed by a strict interpretation of the *Meroni* doctrine are one of the reasons mentioned for the pursuance of a decentralised approach to the supervision of securities business, which mainly relies on national financial supervisors, instead of the application of a US type approach where centralised supervision by the SEC co-exists with that conducted by the State regulators.¹³⁴

In the US the allocation of regulatory and supervisory powers between Federal and State regulators has generally been based on the approach suggested by the economics of federalism, whereby cross-border externality-raising issues are addressed by federal agencies while local matters are considered by State regulators.¹³⁵ By way of example, in 1996 the National Securities Markets Improvement Act was adopted which *inter alia* reallocated federal and state responsibilities for the regulation of investment advisors which at the time were registered with the SEC.¹³⁶ The Act created a division of responsibility that concentrated SEC supervision on those advisers who are associated with collective investment schemes or who have more than \$25 million under management.¹³⁷ The reallocation of regulatory responsibility was triggered by Congress’ concern that the SEC’s resources were insufficient to supervise the increasing

¹³² Geradin (*n131*).

¹³³ *Mistretta V. United States* 488US361,372 (1989).

¹³⁴ Geradin (*n131*).

¹³⁵ On economics of federalism, see amongst others: C Esty and D Geradin (eds), *Regulatory competition and economic integration: Comparative Perspective* (Oxford 2001).

¹³⁶ J Cox, R Hillman, D Langevoort, *Securities Regulation: Cases and Materials* (Wolters Kluwer 2013), Chapter 19 ‘The Investment Advisers and Investment Company Acts of 1940’ 1079.

¹³⁷ Cox et al (*n136*) 1079.

number of advisers, many of which were small and operating only on a State level.¹³⁸ Congress was also concerned with the cost imposed on investment advisors that operated in a number of States and which were subject to overlapping Federal and State regulation.

Congress came to the conclusion that if the then overlapping regulatory responsibilities of the SEC and the States were divided by making the States responsible for small investment advisors and the SEC responsible for large firms, the regulatory resources of the SEC and the States could be put to better and more efficient use.¹³⁹ Therefore, the clear division of power between SEC and the state regulators was also justified on the basis that costs of diverse rules and supervision outweighed the benefits. The Dodd-Frank Act has further strengthened this separation of powers by broadening the competence of State regulators to investment advisers who have more than \$100 million under management.¹⁴⁰ Within the context of the “unfinished agenda”¹⁴¹ of the governance model for the supervision of securities regulation in Europe, certain benefits could be derived from a system such as the one described above.

The recent CJEU ESMA ruling which militates towards a more flexible interpretation of *Meroni*, suggests that the time may be ripe for a reconsideration of the discretionary powers granted to ESMA in the field of regulation and the division of tasks between ESMA and national financial supervisors by applying the tools provided by the economics of federalism.¹⁴² However, a review of the division of tasks between ESMA and national financial supervisors would have to be kept within the confines permitted by the principle of subsidiarity, which restricts community action to what is strictly necessary for the European needs.¹⁴³ Subsidiarity is a two-way principle, while it appears to favour decentralisation, centralisation can be justified by reason of exactly the same principle on account of scale and cross-border externalities arguments.¹⁴⁴

¹³⁸ SEC, ‘Rules Implementing Amendments to the Investment Advisers Act of 1940’ Release No IA-1601 (1996) <<http://goo.gl/MbZd9d>>accessed 07.03.14.

¹³⁹ SEC (n138).

¹⁴⁰ Cox et al (n136) 1079.

¹⁴¹ This usage is borrowed from Lastra (n119) 65.

¹⁴² The European Commission is currently reviewing the European System of Financial Supervision: Commission, ‘Public Consultation: ESFS’ 26.04.13 Review<<http://goo.gl/BB18UD>>accessed 02.03.14.

¹⁴³ TFEU, article 5(3) – formulates the principle of subsidiarity.

¹⁴⁴ J Pelkmans, ‘An EU Subsidiarity Test is Indispensable’ (2006) 41(5) Intereconomics 249-254.

Therefore, it is reasonable to suggest that the questions of whether the present system of decentralised supervision should in part be replaced by centralisation depends on whether cross-border activity of financial entities have gained such a great significance in terms of European stability that centralised supervision is justified as it would be better equipped to prevent financial debacles. It follows that in EU securities regulation an argument in favor of centralisation can be made on the basis that decentralised shared supervision of a large cross-border financial entity could be highly inefficient, ineffective and, as a consequence of fragmentation, may not be adequate to achieve the systemic stability objectives of regulation. Moreover, because of a home bias in enforcement by financial supervisors, actions are normally directed at entities with a strong presence in the home jurisdiction, as opposed to subjects who operate extraterritorially.¹⁴⁵ As a consequence, supervision is unlikely to be applied efficiently in cases where the impact of failure is diffusely multinational, which, in turn, further strengthens the argument for centralised supervision of large cross-border financial entities.

On this account, one may argue in favour of a ‘Champions League’ model of European supervision of securities regulation whereby large cross-border operators in the field of securities business would be supervised by ESMA, while other operators would continue being supervised at national level.¹⁴⁶ This would increase the efficiency of supervision of large cross-border operators and is also said to be beneficial as it allows a certain degree of competition between the supranational (federal) and the national financial supervisors, which when combined with mechanisms for cooperation, may enhance supervisory efficacy and efficiency more than inter-jurisdictional horizontal competition which currently exists at EU level.¹⁴⁷ Nonetheless, the proposed model for supervision would need to take into account the characteristics of the market where the financial entity is undertaking its activity, including the degree of homogeneity and integration within such market, and the extent to which the protection of investors

¹⁴⁵ D Langevoort, ‘Structuring Securities Regulation in the European Union: Lessons from the US Experience’ in G Ferrarini and E Wymeersch, ‘Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond’ (Oxford 2006).

¹⁴⁶ This is an adaptation of a supervisory model for banks proposed in R Lastra, ‘Accountability and Governance: Banking Union Proposal’ November 2012 DSF Policy Paper, No.30 <<http://goo.gl/apX2Ve>> accessed 02.01.14.

¹⁴⁷ Esty et al (*n135*) 31.

requires proximity of supervision.¹⁴⁸

In the context of UCITS, chapter 5 examines the future of financial supervision and compares the centralised approach with the national approach. The point is made that with regard to UCITS, which is a retail investment product where preferences vary across borders¹⁴⁹, regulation should continue being a matter that is mainly decided at European level, while supervision should remain a national competence. This approach differs from that in the US where a national integrated market for collective investment schemes exists and where, as examined in chapter 3, after the 1938-1940 SEC Report on market malpractice in the field of investment management¹⁵⁰, policy makers established the SEC as the main regulator and supervisor of the sector in terms of the ICA 1940. The severe malpractices in this field uncovered by the SEC justified the application of a federal solution for regulation and supervision of collective investment schemes to ensure that a common standard of investor protection would be applied across all of the US.

Conversely, the European approach based on European regulation and national supervision is consistent with the needs of supervision for UCITS where differences in national cultural and market conditions and language barriers still prevail. Decentralised national supervision should therefore remain the European supervisory model for UCITS. This means that the call that some authors have made for centralised European supervision of securities business in general¹⁵¹ do not appear to factor in the specific needs of the supervision of retail investment products and services such as UCITS. A ‘Champions League’ model of European supervision of securities regulation would appear to be more appropriate in the circumstances.

¹⁴⁸ E Wymeersch, ‘Europe’s New Financial Regulatory Bodies’ (11.04.11) <<http://ssrn.com/abstract=1813811>>accessed 22.02.14;

¹⁴⁹ BME Consulting, ‘The EU Market for Consumer Long-Term Retail Saving Vehicles: Comparative Analysis of Products, Market Structure, Costs, Distribution Systems and Consumer Saving Patterns’ Final Report 15.11.07 <<http://goo.gl/Nbmkhh>>accessed 02.03.14.

¹⁵⁰ ‘Report on the Study of the Securities and Exchange Commission on Investment Trusts and Investment Companies pursuant to Section 30 of the Public Utility Holding Company Act of 1935 (1938-1940)’ <<http://goo.gl/7LP5jq>>accessed 15.03.14.

¹⁵¹ M Andenas, ‘Who is going to supervise Europe’s financial markets’; E Pan ‘The Case for a Single European Securities Regulator’; E Avgerinos, ‘The need and rationale for a European Securities Regulator’ and G Thieffry, ‘After the Lamfalussy Report: The First Steps toward a European Securities Commission’ all in M Andenas and Y Avgerinos, *Financial Markets in Europe: Towards a Single Regulator?* (Klumer 2003).

In the final analysis, granting ESMA more discretion in the context of large cross-border financial entities that operate in homogenous institutional markets, such as central counterparties ('CCP'),¹⁵² the client base of which are normally banks and other financial institutions, would appear to be an acceptable proposal on the basis of the assumptions of the economics of federalism as encapsulated in the principle of subsidiarity, as for a CCP shared supervision may be highly inefficient when compared to centralisation and may not be adequate to safeguard systemic stability. On the other hand, in the context of UCITS, which is a retail product, the national approach coordinated by ESMA remains the best possible alternative as it provides for proximity of supervision and a proper understanding of national cultural differences. Within this context coordination and supervisory convergence remain fundamental criteria to strengthen cooperation between financial supervisors and mutual recognition between Member States.

ESMA has been vested with various tools for the promotion of convergence and cooperation amongst national financial supervisors, including: **[i]** the power to investigate a breach of EU law by a national financial supervisor and demand compliance¹⁵³; **[ii]** the power to resolve disagreements between national financial supervisors;¹⁵⁴ **[iii]** the role to promote and the power to participate in colleges of national financial supervisors and on-site inspections;¹⁵⁵ **[iv]** the role to stimulate and facilitate the delegation of tasks and responsibilities among national financial supervisors;¹⁵⁶ **[v]** the power to issue Level 3 Guidance with a name and shame enforcement tool to discipline compliance;¹⁵⁷ and **[vi]** the power to carry out peer reviews of supervisory practices at national level and taking different forms of supervisory action to ensure the rectification of any identified inconsistencies.¹⁵⁸

¹⁵² N.B. A collective investment scheme may also qualify as a systemically relevant. See FSB and IOSCO, 'Consultation Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global SIFI' (08.01.14) <<http://goo.gl/aN0mcL>> accessed 23.01.14.

¹⁵³ Regulation (EU) No1095/2010, article 17.

¹⁵⁴ Regulation (EU) No1095/2010, articles 19–20.

¹⁵⁵ Regulation (EU) No1095/2010, articles 21–21.

¹⁵⁶ Regulation (EU) No1095/2010, article 28.

¹⁵⁷ Regulation (EU) No1095/2010, article 16.

¹⁵⁸ Regulation (EU) No1095/2010, articles 29-30.

The 2010 Omnibus Directive introduced powers for the issue of technical standards in relation to twenty-two articles of the 2009 UCITS IV Directive. The relevant powers to issue technical standards will be further amplified with the adoption of the 2012 UCITS V Proposal. The opportunity to draft technical standards is a legislative tool that gives ESMA the opportunity to transform soft-law, such as CESR Level 3 Guidance, into hard-law technical standards, particularly, where the former are of significant importance in the functioning of the internal market, such as the Level 3 Guidance on MMFs mentioned earlier on in this chapter. Hard-law helps in overcoming issues of enforceability with national financial supervisors. Alternatively, to ensure compliance with Level 3 Guidance, ESMA could apply one of its various soft-law regulatory and supervisory tools for enforcement provided in terms of the ESMA Regulation. By applying these tools, fragmentation at Level 3 is overcome as soft-law is transformed into (almost) hard-law.

While the limitations of CESR at Level 3 had already triggered evolutionary type improvements¹⁵⁹, the establishment of ESMA symbolises the most important step taken by the EU in the creation of a wide-ranging pan-European supervisory framework in securities business to supplement the extensive EU financial regulation in this field. The financial crisis and the identified shortcomings in regulation and supervision were the main trigger for the establishment of ESMA. One may however contend that the resulting governance mechanism for financial regulation and supervision was the product of an evolutionary process rather than a spontaneous reaction to the failures identified as a consequence of the financial crisis. Indeed, one may argue that the governance of ESMA is the result of reflection on the identified weaknesses of CESR, particularly its failure to achieve any suitable degree of supervisory convergence at Level 3, which occurred a long time before the economic and social impact of the crisis generated the impetus for change.

In the final analysis, the combination of the governance mechanism for regulation and supervision vested in ESMA may be used in the field of UCITS to support mutual recognition based on *quasi*-maximum harmonisation to overcome the remaining identified regulatory and supervisory barriers to cross-border business of UCITS.

¹⁵⁹ Commission (n101).

4.5 Level 4: Mechanisms for Enforcement

Level 4 concerns the strengthening of control, on the part of the Commission, as guardian of the EU Treaties, over the implementation and application of financial regulation by Member States through the various tools available to it for this purpose. The Lamfalussy Report identified lack of enforcement of the implementation by Member States as a particular problem for the further integration of the internal market.

Enforcement at Level 4 is critical since uniform transposition, implementation and interpretation of harmonised regulation is essential for the proper operation of mutual recognition between Member States. However, the transposition of the Directives adopted during the FSAP phase of the Lamfalussy Process by Member States became one of the bottlenecks of the process.¹⁶⁰ This created legal uncertainty and disrupted cooperation arrangements between Member States. The Commission reacted to this by initiating infringement proceedings against non-compliant Member States. A case in point, is the transposition process of the MAD, where the Commission initiated fifty-seven infringement proceedings against sixteen Member States within less than nine months from the deadline set for the transposition of the Directive.¹⁶¹

The transposition of 2009 UCITS IV Directive is an example of the extent to which Member States continued to fail in their efforts to transpose and implement financial regulation within the timeframe set for such a purpose in Directives. Member States had to have measures in place to transpose the Directive by the 30 June 2011. Four months after this deadline, most Member States had not yet transposed the Directive, which situation continued for a number of months thereafter.¹⁶² This state of affairs produced legal uncertainty regarding the extent to which the benefits of the Directive, particularly those that emerge from the new mechanisms for consolidation of UCITS, could also be derived in the non-compliant Member States.¹⁶³

¹⁶⁰ Alford (*n*47).

¹⁶¹ R Kelemen, 'Eurolegalism: The Transformation of law and Regulation in the European Union' (Harvard University 2011) 115.

¹⁶² B Abouljian, 'Esma helps clarify benefits of Ucits IV' Financial Times 16.10.11; and PriceWaterhouseCoopers, 'UCITS IV News', Issue 19–December 2011.

¹⁶³ ESMA, 'Opinion: Practical arrangements for the late transposition of the UCITS IV Directive' ESMA/2011/342, 13.10.11.

Moreover, different interpretations of the provisions of the Directive continued. It has been pointed out that amongst others, Member States took different approaches on whether a management company could delegate administrative duties to the depositary. The depositary has the role of monitoring the functions of the management company and must be independent from the management company. Therefore, the delegation of administrative duties to a depositary may generate conflicts of interest that could have detrimental effects on the investor protection safeguards in the Directive. Research on the implementation of the 2009 UCITS IV Directive has demonstrated that while Austria, Germany, Italy, Luxembourg, Poland, Netherlands, Sweden and UK allow the delegation by a management company of administrative tasks to the depositary, Belgium, France, Ireland and Spain do not allow such delegation to occur.¹⁶⁴ This is not the only area where an uneven implementation of the 2009 UCITS IV Directive has been applied by the Member States.¹⁶⁵

Notwithstanding, due to bureaucratic fatigue at the Commission¹⁶⁶ and its general reluctance to jeopardise working relations with Member States¹⁶⁷, the Commission has not always been keen to take prompt infringement proceedings for failure by Member States to implement. Instead, in certain instances the Commission has demonstrated a preference for a more pro-active approach to better implementation based on soft-law mechanism such as the organisation of transposition workshops, the publication of question and answer guidance on the interpretation of particular provisions of Level 1 and Level 2 legislation, and the use of transposition score boards, while leaving hard-law measures, such as infringement proceedings, to address only egregious cases of non-compliance.¹⁶⁸ For example, with regard to the implementation of the 2009 UCITS IV

¹⁶⁴ Commission, Transposition League Table as at 15.12.11<<http://goo.gl/MSO5XX>>; PriceWaterhouseCoopers, 'UCITS IV News' Issue 19-December 2011<www.pwc.lu>; and Deloitte, 'UCITS IV six months on. Can the Directive deliver on efficiency' January 2012<www.deloitte.com>accessed 15.04.13.

¹⁶⁵ N Reeve, 'IMA calls on regulators to clarify UCITS IV stance' FT Advisors, 16.12.12<www.ftadviser.com>and PriceWaterhouseCoopers, 'UCITS IV News' Issue 20, May 2012<www.pwc.lu>accessed 15.04.13.

¹⁶⁶ Schaub (*n15*) 116.

¹⁶⁷ Alford (*n47*).

¹⁶⁸ C McCreedy, 'Assessment of the Integration of the Single Market for financial services by the Commission', Speech/04/515 CESR Conference Paris, 06.12.04. See also D Sabalot, 'The World Turned Upside Down: Radical Ideas in Regulation' (2006) 21(4) Journal of International Banking and Financial Law 147 and M Day, 'Some thoughts on the financial services action plan following the UK Presidency' (2006) 27(5) Company Lawyer 133–133.

Directive, the Commission only commenced infringement proceedings against failing Member States after fifteen months from the deadline for implementation.¹⁶⁹ Given the lengthy processes involved with regard to the taking of infringement proceedings, the Commission's approach at Level 4 may be considered as justified, even though not exceptionally effective.

In the final analysis, the late transposition by Member States and different interpretations of the requirements in the Directive, point towards the weaknesses of those mechanisms, which were applied as part of the implementation of the Lamfalussy Process for the purpose of the 2009 UCITS IV Directive and which are examined in detail in the next section of this Chapter. These clearly qualify as limitations inherent in the governance mechanism for mutual recognition.

4.6 Conclusion

The *raison d'être* of the Lamfalussy Process was that of improving the governance mechanism for EU financial regulation and supervision. An analysis of the literature regarding the material working of the Lamfalussy process, leads to the general conclusion that this process has, overall, generated positive outcomes.¹⁷⁰ The examination of the Lamfalussy Process in the context of the 2009 UCITS IV Directive supports this view.

The law-making process at Level 1 and 2 achieved *quasi*-maximum harmonisation of financial regulation inside an environment, which increased the levels of consultation, transparency, debate and the responsiveness of the law-making system to market developments. The efforts of CESR at Level 3 improved cooperation between national financial supervisors. This created the opportunity for better convergence in the interpretation and practical implementation of financial regulation, thereby

¹⁶⁹ Commission, 'November infringements package: main decisions', Memo/12/876, 21.11.12

¹⁷⁰ Commission, 'Review of the Lamfalussy process – Strengthening supervisory convergence' COM(2007)727final Brussels, 20.11.2007, J MacMahon and N Moloney, 'Financial Market Regulation in post-Financial Services Act Plan era' (2006) 55(4) International & Comparative Law Quarterly 982–992 and G Gari and R Lastra, 'Assessing the Lamfalussy Process: Successes and Failures' (2009) 24(7) Journal of International Banking and Financial Law 379 and Moloney (*n103*). For an analysis of the legislative framework which emerged from this process, see: E Avgouleas, 'EC Securities regulation, a single regime for an integrated securities market: harmonized we stand, harmonised we fall? Parts 1 and 2' (2007) 22(2)/(3) Journal of International Banking Law and Regulation 79–87 and 153–164.

strengthening mutual trust between national financial supervisors.

Overall, the Lamfalussy Process established the tools for the strengthening of mutual recognition between Member States and, by so doing, created the right environment for a broader internal market in financial services. However, the experience regarding the functioning of the Simple Control Mechanism Procedure for delegated acts has not proved to be a positive experience and should be reconsidered. The analysis also points to a number of limitations of the governance mechanism based on minimum harmonisation, which have continued to prevail in the form of inconsistent implementation and interpretation of EU law by Member States and the application of discretions such as national marketing rules. These weaken mutual recognition between Member States.

To address some of these limitations, the Lamfalussy Report called for more use of Regulations for the purpose of financial regulation, which do not require transposition into national law and are immediately applicable across the EU.¹⁷¹ However, in the application of the Lamfalussy Process, while legislators were more inclined to use Regulations,¹⁷² Directives remained the predominant legal instrument¹⁷³, with all Level 1 measures and most of the Level 2 measures in the field of securities regulation being adopted in this legislative form.¹⁷⁴ This is also true with regard to the legislative framework of the 2009 UCITS IV Directive.¹⁷⁵ This approach reflected the agreement set in the Treaty of Amsterdam Protocol on the application of the principles of subsidiarity and proportionality.

Some eight years after the Lamfalussy Report, a recommendation in favour of Regulations as the legislative instrument for financial regulation, was again made in the

¹⁷¹ Lamfalussy Report (*n1*) 26.

¹⁷² N Moloney, 'Time to take stock on markets: the Financial Services Action Plan concludes as the Company Law Action Plan rolls out' (2004) 53(4) *International and Comparative Law Quarterly* 999–1012.

¹⁷³ J Coffey and J Overett Somnier, 'The Market Abuse Directive – the first use of the Lamfalussy Process' (2003) 18(9) *Journal of International Banking Law and Regulation* 376.

¹⁷⁴ MAD – 1 framework Directive, 3 implementing Directives and 1 implementing Regulation; MiFID – 1 framework Directive, 1 implementing Directive and 1 implementing Regulation; PD – 1 framework Directive and 1 implementing Regulation; and TD – 1 framework Directive, 1 implementing Directive and 1 implementing Regulation.

¹⁷⁵ UCITS IV Directive is made up of 1 framework Directive, 2 implementing Directives and 2 implementing Regulations.

DeLarosiére Report, which also proposed the establishment of a single rulebook for financial regulation in order to do away with inconsistencies and eradicate regulatory arbitrage.¹⁷⁶ The financial crisis created the impetus for policy-makers to push forward with more extensive harmonisation.

It is submitted that while the use of Directives is not a weakness *per se*, the use of this legislative instrument for the purpose of harmonisation resulted in the resurfacing of a number of limitations that occur as a consequence of its peculiar nature. These take the form of: **[i]** legal uncertainty which is created as a consequence of the late transposition of Directives by the Member States; **[ii]** the fragmented approaches to implementation and interpretation during and after the transposition phase; and **[iii]** the opportunities to gold-plate EU legislation by including additional regulation at national level which, in turn, creates barriers to cross-border business.¹⁷⁷ In addition, at Level 4 the Lamfalussy Process failed to improve Member States' performance with regard to the transposition of Directives issued at Level 1 and Level 2. This increased even further the difficulties arising from the use of this legislative instrument.

The use of Directives pays more respect to Member States' sovereignty. However, legal certainty would, in theory, have been improved had the legislator used more Regulations as the legislative tool for the internal market. As will be contended further on, while Regulations tend to achieve maximum harmonisation and therefore should minimise the opportunities for uneven implementation by Member States, the use of Regulations is, however, not the universal remedy to the difficulties that emerge from the different implementation and interpretation of Directives at national level. In the final analysis, Directives remain a valid legislative instrument to cater for instances where the legislator wants to provide for divergences at national level stemming from different legal traditions.

The following chapter examines the application of the *quasi*-maximum harmonisation technique (a mixture of minimum harmonisation and maximum harmonisation) to achieve mutual recognition. Chapter 5 also reviews the areas where a Directive and a

¹⁷⁶ The High-Level Group on Financial Supervision 'DeLarosiére Report' (Brussels 25.02.09) 29 <<http://goo.gl/CroZY>>accessed 15.03.14.

¹⁷⁷ C Gerner-Beuerle, 'United in diversity: maximum versus minimum harmonization in EU securities regulation' (2012) 7(3) Capital Markets Law Journal 317-342.

Regulation were applied at Level 2 and the resulting outcome in terms of consistency of implementation of EU Law. The analysis demonstrates that the use of Regulations may still result in an uneven implementation and interpretation of financial regulation at national level, particularly in instances where the outcome of such Regulation creates insufficient harmonisation, inadequate regulatory convergence, and limited convergence of supervisory practices if at all.

In the final analysis, as will be demonstrated in chapter 5, while *quasi*-maximum harmonisation has proved to be the optimal tool to continue developing the regulatory framework for UCITS, the tools for regulatory and supervisory convergence under CESR have proved to be insufficient and, at times, ineffective due to uneven implementation of Level 3 Guidance which created yet another layer of fragmentation in financial regulation. Nonetheless, the mechanisms for cooperation under the ESMA Regulation could be applied as tools for reflexive governance of financial supervision which, when combined with a framework for the strengthening of the governance of national financial supervision, could emerge as the optimal solution to resolve the remaining internal market issues on UCITS.

Chapter 5

QUASI-MAXIMUM HARMONISATION OF REGULATION AND GOVERNANCE OF SUPERVISION: A FRAMEWORK TO ADDRESS THE REMAINING BARRIERS TO THE CROSS-BORDER ACTIVITY OF UCITS

5.1 Introduction

Chapter 5 examines the substantive regime set in the 2009 UCITS IV Directive and the manner in which this seeks to broaden the internal market for UCITS and the hard-law and soft-law tools used for this purpose. It examines the manner in which the 2009 UCITS IV Directive achieves *quasi*-maximum harmonisation of regulation. The chapter also examines the governance mechanism for supervision of UCITS.

The chapter argues and demonstrates that while *quasi*-maximum harmonisation of regulation has proved to be the optimal mechanism for the development of the regulatory framework for UCITS, the soft-law tools applied for the purpose of the 2009 UCITS IV Directive did not achieve an optimum level of convergence, which in terms of the Lamfalussy process, is an essential ingredient for the operation of mutual recognition. The analysis determines that a number of limitations of the governance mechanism and the regulatory framework under the 1985 UCITS Directive resurfaced, although to a lesser extent, in the implementation of the 2009 UCITS IV Directive. These limitations appear in the different interpretations and implementation of the requirements of the Directive as well as in the application of national marketing rules.

These limitations continue to distort the effective operation of mutual recognition in the field of UCITS. Notwithstanding the Lamfalussy Report's recommendation that supervisory convergence is an essential element for mutual recognition, the implementation of the 2009 UCITS IV Directive was characterised by a complete lack

of convergence of supervisory practices. Furthermore, the depositary has not been provided with access to the internal market.

Chapter 5 identifies a number of options which may be employed in overcoming each of these limitations, which options are based on the mechanisms devised by EU policy-makers to address the regulatory and supervisory concerns that emerged from the financial crisis.

The central argument of the chapter is that in order to overcome the remaining regulatory and supervisory barriers to cross-border business in the field of UCITS, mutual recognition based on *quasi*-maximum harmonisation would have to be complemented with reflexive governance of financial supervision, based on cooperation arrangements for cross-border UCITS structures and mutual monitoring through peer reviews. These mechanisms may be applied as vehicles for experimentation and mutual learning and as a basis to create a framework for supervisory convergence.

The chapter also argues that the strengthening of mutual trust between financial supervisors is critical for the proper functioning of reflexive governance of financial supervision. The chapter makes the point that mutual trust may be strengthened if the autonomy of financial supervisors from political and industry influence and the accountability structures to democratically elected institutions and peers are guaranteed through a specific regulatory framework created for this purpose at EU level.

Chapter 5 is divided into three additional sections. Section 5.2 examines the substantive regulation set in the 2009 UCITS IV Directive and identifies the remaining regulatory and supervisory barriers that have an impact on the effective operation of the mechanisms set in the Directive. This section also considers the current state of affairs of the governance of supervision in the context of UCITS. Section 5.3 analyses and proposes a mechanism of reflexive governance of financial supervision as the solution to the remaining barriers to cross-border activity of UCITS. Section 5.4 examines the importance of independence and autonomy of financial supervision and accountability for the strengthening of mutual trust between financial supervisors and makes a set of proposals for this purpose. Concluding remarks are made at the end of the chapter.

5.2 The 2009 UCITS IV Directive: *Quasi-Maximum Harmonisation of Regulation for a Higher Degree of Mutual Recognition*

The framework set in the 2009 UCITS IV Directive is based on the internal market principle that a deep pan-European investment market can only be achieved through mutual recognition based on harmonised investor protection requirements. To that end, the regulatory framework set in 2009 UCITS IV Directive places significant emphasis on investor protection by implementing, *inter alia*, authorisation requirements for each of the new elements set in the Directive and tight transparency rules to benefit investors.

The analysis in the chapter demonstrates that in order to limit the discrepancies in the application of these requirements and therefore to achieve homogeneous investor protection across the EU, the Level 2 measures under the 2009 UCITS IV Directive have generally been drafted with rigid and detail requirements to achieve *quasi-maximum* harmonisation. From the analysis a number of lessons can be drawn with respect to the remaining regulatory and supervisory barriers to the effective cross-border activity of UCITS.

The analysis in this section covers the new areas of substantive regulation covered by the 2009 UCITS IV Directive. These are: [i] the mechanisms for a more effective passport for UCITS, in the form of a simplified notification procedure supported by the KIID; and [ii] the tools for consolidation of the European funds industry, namely: the mechanism for mergers; the framework for the establishment of master feeder structures; and the management company passport.

5.2.1 Simplified Notification Procedure

The application of a notification procedure for passporting a financial institution from its home Member State to a host Member State has been a crucial tool for the development of the internal market. It allows financial institutions that are authorised in a Member State to passport into and provide their services in other Member States, without requiring a separate authorisation in those States.

As analysed in chapter 3, the 1985 UCITS Directive established a passporting mechanism for UCITS. It required the management company to make a notification directly to the host financial supervisor, which had supervisory powers over the passporting UCITS. The Directive stipulated that cross-border marketing of UCITS had to comply with national marketing rules, a field of financial regulation where no degree of mutual recognition exists. The host financial supervisor was allowed a period of two months to verify compliance with national marketing rules. This period was on a number of occasions extended to up to nine months *inter alia* on grounds that the information presented by the management company was incomplete or that the structure of the particular UCITS was not compliant with the requirements of the Directive as applied in the host Member State.¹

The lack of regulatory convergence with regard to the application of the 1985 UCITS Directive, the length of time required in order to get access to the market of the host Member State, the differences in the national marketing rules applicable in the host Member States and the application of protectionist measures by financial supervisors, created uncertainty and confusion on the operation of the passport.²

Notwithstanding every effort by CESR to achieve regulatory convergence and mitigate any supervisory barriers to the process for cross-border passporting of UCITS, through the application of Level 3 Guidance³, the obstacles to unhindered cross-border activity persisted. Mutual recognition on the basis of soft-law did not work as Member States took an uneven or incomplete approach to its implementation and CESR did not have the right tools to enforce the Level 3 Guidance. This was a limitation of Level 3 Guidance as a mechanism to strengthen mutual recognition.

A more efficient governance and regulatory mechanism for passporting had to be developed if mutual recognition in the field of UCITS was to operate properly. The 2009 UCITS IV Directive made an overhaul of the hard-law mechanism for the passporting of UCITS. The burdensome management company-to-host financial

¹ StateStreet, 'UCITS IV: The Path to Greater Efficiency', (2009) <<http://goo.gl/4yn2yG>> accessed 05.02.11.

² N Moloney, 'EC Securities Regulation' (Oxford 2008) 265.

³ CESR, 'Guidelines to simplify notification procedures of UCITS', CESR/06-120b, June 2006; and CESR, 'Peer Review: CESR's Guidelines to simplify the notification procedure of UCITS', CESR/09-1034, January 2010 <<http://goo.gl/bvWyNY>> accessed 16.04.14.

supervisor registration procedure was replaced with a MiFID⁴ type process based on home financial supervisor-to-host financial supervisor filing of notifications. This was complemented by substantive requirements, which prevent a host financial supervisor from applying ex-ante grounds to refuse the UCITS access to its market.

Under the 2009 UCITS IV Directive, as supplemented by the Level 2 Commission Regulation on passporting and the exchange of information,⁵ the management company is required to make the necessary notification to its home financial supervisor which, in turn, is to use a standard notification letter to notify the host financial supervisor. The home financial supervisor is required to notify the host financial supervisor within ten working days of receipt of the notification from the UCITS.⁶ The host financial supervisor is required to acknowledge receipt within five working days.⁷ The specific content and format of the notification letter is also regulated in terms of the Commission Regulation. To facilitate the process the Commission Regulation also stipulates that the notification is to be made by electronic means and through a designated e-mail address.

In order to ensure an unobstructed notification process, the UCITS is allowed to commence activity in the host Member State as soon as it receives the notification from the home financial supervisor that the relevant notification has been sent to the host financial supervisor.⁸ Therefore, legally the UCITS is not required to await any form of confirmation from the UCITS host financial supervisor. This points to the policy-makers' intention to remove any form of supervisory barriers to access to the internal market. However, certain inconsistencies still prevail. In 2012 a stakeholder pointed out:

... the approach taken by some countries has been that a UCITS is not permitted to access the market until it has been notified by the home regulator that the host regulator has received the complete notification package. Under Commission Regulation No 584/2010, the host Member State has up to five working days from receipt of the notification package to notify the home regulator that it has received the complete notification package. As a result, UCITS are having to

⁴ Directive 2004/39/EC.

⁵ Regulation (EU) No584/2010.

⁶ Directive 2009/65/EC, article 93.

⁷ Regulation (EU) No584/2010, article 5.

⁸ Directive 2009/65/EC, article 93.

wait up to 15 working days from submission of a complete notification package before they can access the markets of certain Member States. This approach is inconsistent with the intention of the UCITS IV Directive and would benefit from clarification to ensure a uniform approach is adopted by all Member States.⁹

The above is yet another example of the internal market difficulties that may emerge from an uneven implementation and interpretation of financial regulation, even where minimum harmonisation has been replaced with a framework which aims at achieving *quasi*-maximum harmonisation. This is a limitation of the regulatory mechanism for mutual recognition set in the 2009 UCITS IV Directive.

Notwithstanding the differences in the implementation of the 2009 UCITS IV Directive, in general, the level of harmonisation and detail achieved in regulating the passporting process applicable to UCITS and the use of a Regulation as the legal instrument for implementing measures in this field, attests to the policy-makers' intention of significantly reducing the possibility of gold-plating and the various possible forms of administrative type obstacles that could be applied by Member States to slow down the passporting of UCITS.

The new provisions also achieve a considerable reduction in the time-line by when the UCITS may start marketing within the host Member States. Overall the streamlined approach does not leave any discretion to the home and host financial supervisors with regard to the processing of a notification. Member States are only given a certain degree of flexibility with regard to the content and the extent of application of national marketing rules. In terms of the 2009 UCITS IV Directive, compliance with these rules may only be verified by the host financial supervisor after the UCITS has accessed its market.¹⁰ Albeit, in the event that the marketing material is non-compliant, the UCITS may be subject to *ex-post* enforcement action by the host financial supervisor. This generates costs, incurred to determine *ex-ante* whether the marketing material is compliant with national marketing rules.

⁹ Irish Funds Industry Association, 'Reply to the Commission's Consultation Document on UCITS' 18.10.12 <<http://goo.gl/Mq725T>> accessed 18.04.13.

¹⁰ Directive 2009/65/EC, recital 64 and article 93.

The new mechanism for the passporting of UCITS, when compared to the framework in the 1985 UCITS Directive, reduced the administrative burden associated with the process for the cross-border marketing of UCITS. However, the application of national marketing rules by host Member States remains an obstacle to the successful operation of the internal market for UCITS. In 2012, a stakeholder pointed out:

The UCITS IV Directive aimed at streamlining the notification process; however, the implementation of such ‘product passport’ is still not fully harmonised among the different Member States, which may add some specific requirements on the distribution of UCITS on their national territory. For example, marketing documents are currently not standardised at EU level and require host regulator approval. More generally, harmonising marketing rules would reduce legal uncertainty and in turn improve the efficient implementation of UCITS IV.¹¹

Differences in national marketing rules applicable in the host Member States and a heavy handed supervisory approach to the enforcement of such rules may render ineffective the simplified notification procedure for cross-border marketing, as obstacles may still arise post access to the market. This is especially relevant where Member States have declared their intention of prohibiting the marketing of a passporting UCITS if its marketing material does not fully comply with the national marketing rules.¹²

To facilitate access to the national marketing rules by a passporting UCITS, Member States are required by the 2009 UCITS IV Directive¹³ to ensure that these rules are easily accessible from a distance and by electronic means. Member States are also required by the Directive to ensure that the information on national marketing rules is drafted in a language that is customary in the sphere of international finance, namely the English language. Yet, difficulties may still occur in finding out what are the applicable national marketing rules in the different Member States.

¹¹ THEAM (BNP PARISBAS) ‘Response to Consultation Document on UCITS’ 18.10.12 <<http://goo.gl/anfPjf>>accessed 18.04.13.

¹² BAFIN note on investment funds<<http://goo.gl/5ZLl1E>>accessed 17.04.13.

¹³ Directive 2009/65/EC, article 91 and Directive 2010/44/EU, article 30.

To verify the adequacy of implementation of the requirements of the 2009 UCITS IV Directive on easy access to the national marketing rules, empirical research was carried out for the purpose of the thesis on the web-site of the financial supervisors of the ten largest Member States by population. The following table summarises the result of the search for the phrases ‘UCITS marketing rules’ or ‘arrangements for marketing’ or ‘UCITS passporting’ performed through the search facility of the web-site of the relevant financial supervisors.

Table 5.1 - Easy Access to National Marketing Rules

Financial Supervisor	Marketing Rules Located - Yes/No
Belgian FSMA ¹⁴	No
Dutch AFM ¹⁵	No
German BAFIN ¹⁶	Yes
French AMF ¹⁷	No
Italian CONSOB ¹⁸	No
Polish FSA ¹⁹	No
Portuguese CMVM ²⁰	No
Romanian CNVM ²¹	Yes
Spanish CNMV ²²	No
UK FCA ²³	Yes

The research established that generally the information on the national marketing rules applicable to a passporting UCITS in the host Member State is not easily retrievable from the web-site of the relevant financial supervisor. Therefore, the implementation of the 2009 UCITS IV Directive does not seem to have facilitated access to the national marketing rules applicable in the host Member State. This is yet another example of the barriers to the cross-border operations of UCITS that surface from the application of national marketing rules. It demonstrates that even though a maximum harmonisation approach to regulation is applied, as in the case of the mechanism for passporting of UCITS and for the disclosure of national marketing rules, this could still result to be unproductive if the harmonised regulation is not implemented and interpreted correctly

¹⁴ Belgian FSMA<www.fsma.be>accessed 17.04.13.

¹⁵ Dutch AFM<www.afm.nl>accessed 17.04.13.

¹⁶ German BAFIN<<http://goo.gl/g4r5ip>>accessed 17.04.13.

¹⁷ French AMF<www.amf-france.org>accessed 17.04.13.

¹⁸ Italian CONSOB<www.consob.it>accessed 17.04.13.

¹⁹ Polish FSA<www.knf.gov.pl>accessed 17.04.13.

²⁰ Portuguese CMVM<www.cmvm.pt>accessed 17.04.13.

²¹ Romanian CNVM<<http://goo.gl/CS5iFG>>accessed 17.04.13.

²² Spanish CNMV<www.cnmv.es>accessed 17.04.13.

²³ UK FCA<<http://goo.gl/7PbK5n>>accessed 17.04.13.

by the Member States. This is another limitation of the regulatory mechanism for mutual recognition set in the 2009 UCITS IV Directive.

In the final analysis, a high degree of harmonisation has proved to be insufficient to eliminate the possible distortions that can arise from uneven implementation and interpretation of EU regulation. Soft-law mechanisms combined with mechanisms that guarantee proper application by financial supervisors, are an essential part of the formula if mutual recognition is to function properly and attain its purpose.

5.2.2 Key Investor Information Document ('KIID')

The KIID forms a significant part of the reinforced investor protection framework established in the 2009 UCITS IV Directive. The KIID was developed on the idea that investor protection can be strengthened through the creation of a document which provides simplified and comparable information on UCITS. The development of the KIID forms an integral part of the Commission's consumer empowerment policy²⁴ and the Commission's attempt to strengthen mutual trust between Member States in the field of UCITS thereby enhancing easy access to internal market.

It has been established that investors suffer from considerable disadvantage, through sub-optimal choices resulting from inadequate transparency and comparability in financial products.²⁵ It is therefore the Commission's policy that financial regulation should create the mechanisms, which empower investors to make optimal decisions by being able to identify their own preferences and the available options in this regard.²⁶ The KIID is based on the investor empowerment model, as it is a tool for helping retail investors to reach informed investment decisions.²⁷ This should, in turn, strengthen the internal market, as more informed investors who are in a position to compare different UCITS should, in theory, support stronger cross-border investment.

The KIID replaced the simplified prospectus introduced by 2001 UCITS III Directive which was aimed at providing investors with understandable information to enable them

²⁴ Commission consumer empowerment <<http://goo.gl/zvIn74>> accessed 22.04.13.

²⁵ Commission, 'Consumer Empowerment in the EU' SEC(2011)469, Brussels, 07.04.11.

²⁶ Commission, (n25).

²⁷ N Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge 2010) 318.

to make informed investment decisions. The simplified prospectus was however the victim of inconsistent implementation by Member States.²⁸ In 2006 the Commission expressed the following concern regarding the effectiveness of the simplified prospectus:

The simplified prospectus was intended to provide investors and intermediaries with basic information about the possible risks, associated charges, and expected outcomes of the respective product. However, it has manifestly failed. In most cases, the document is too long and not understood by its intended readers. It has been the victim of divergent implementation and gold-plating: the relevant Commission Recommendation has been honoured more in the breach than in the practice. The result is a massive paper-chase of limited value to investors and a considerable overhead for the fund industry.²⁹

The simplified prospectus had failed to achieve the purpose for which it had been created making it essential for the Commission to rethink the whole simplified disclosure procedure for UCITS.³⁰ The need to establish the KIID became more prevalent as a consequence of the financial crisis, which revealed that sophisticated financial instruments had been sold to investors on the basis of documents that were not understood by investors.³¹ The financial crisis exposed the potential mis-selling that could occur where investors acquire financial products without understanding fully the nature of the product. This state of affairs exacerbated the necessity to require clearer, consistent and simplified disclosure on financial products to investors.

Given the experience with the simplified prospectus, the Commission could ill afford getting the formula for simplified and comparable information to investors wrong for the second time. The KIID was the result of meticulous research and consultation with stakeholders carried out by the Commission and CESR on the fundamental information which an investor requires to make an investment decision and on the format in which

²⁸ Commission, 'White Paper on enhancing the single market Framework for Investment Funds' COM(2006)686, 15.11.06. 12<<http://goo.gl/dQVh4D>>accessed 16.03.14.

²⁹ Commission, (n29) 10.

³⁰ T Derossi and others, '*Newcits: Investing in UCITS Compliant Hedge Funds*' (Wiley Finance 2010) 22.

³¹ Commission, 'KID for packaged retail investment products – FAQ', 03.07.12<<http://goo.gl/7tMMaS>> accessed 17.11.12.

that information should be presented.³² The result being a two-page document which contains information that should allow an investor to understand the UCITS being offered.

The Commission and CESR established that the information necessary for investment decisions includes: **[i]** the UCITS' investment policy and objectives; **[ii]** the UCITS' risk reward profile; **[iii]** the costs and charges incurred when investing in the UCITS; and **[iv]** its past performance. The 2009 UCITS IV Directive stipulates the detailed requirements on each of these elements which all together formulate the KIID. The sequence in which these elements should be presented is also regulated, as it was deemed essential for the organisation of the information to be logical and the language appropriate for retail investors.³³ The sequence was established on the basis of investor preferences as determined by the Commission in 2009 further to a study that tested the contents and form of the KIID.³⁴

The regulatory framework for the KIID established in the 2009 UCITS IV Directive is supplemented by a Level 2 Commission Regulation on the KIID³⁵ and six pieces of CESR Level 3 Guidance. The level of detail in which the regulatory framework goes into describing the content and the mechanics that should be applied in formulating a KIID is significant and seeks to ensure a uniform approach to the implementation of the KIID without any inconsistencies. Therefore, to address the inefficiencies of the past, the 2009 UCITS IV Directive replaced the regulatory framework for a simplified prospectus, which was based on the principle of minimum harmonisation, with a regulatory framework for the KIID that aims at achieving maximum harmonisation. This is sustained by a specific requirement that the KIID should be issued and used without any supplements.³⁶ This supports the aim that no room should be left for possible gold plating by the Member States.

³² Commission, 'Impact assessment: Legislative Proposal Amending the UCITS Directive' SEC(2008)2263 16.07.08. See in particular annex 1 on procedural issues and consultation of interested parties 37–42 <<http://goo.gl/jSabri>> accessed 16.03.14.

³³ Regulation (EU) No 583/2010, recital 4.

³⁴ IFF Research and YouGov, 'UCITS Disclosure Testing Research Report' (June 2009) <<http://goo.gl/jakKzG>> accessed 17.06.11.

³⁵ Regulation (EU) No 583/2010.

³⁶ Directive 2009/65/EC, article 78 (6).

In areas such as the KIID, where maximum harmonisation has been realised through the application of a Regulation, mutual recognition would not, in first instance, appear to remain relevant to that specific area of regulation. Such a Regulation is applicable across the EU on the basis of a single regulatory framework. However, when considered within the context of the functioning of the internal market for UCITS, where minimum harmonisation of regulation is still common, instances of maximum harmonisation should be interpreted as a means to strengthen the overall mutual recognition between Member States. Indeed, it reinforces mutual trust between these States in areas which are exceptionally important for accomplishing the objectives of financial regulation, particularly the protection of the investors in UCITS.

The rationale for selecting a Regulation as the legal instrument for the Level 2 measures and the objective of achieving maximum harmonisation is explained in the Commission Regulation:

The form of a Regulation is justified as this form alone can ensure that the exhaustive content of the key investor information is harmonised. Furthermore, a key investor information document will be more efficient where requirements applicable to it are identical in all Member States. All stakeholders should benefit from a harmonised regime on the form and content of the disclosure, which will ensure that information about investment opportunities in the UCITS' market is consistent and comparable.³⁷

Nonetheless, specific areas of insufficient harmonisation have been identified which have had an impact on the way in which the regulatory framework for the KIID has been applied. In 2012 a stakeholder made the following remarks on the negative consequences of insufficient harmonisation:

Some definitions are still missing in the UCITS IV directive, which lead to its provisions being interpreted in different ways by the national authorities of the Member States. For instance, the concept of “fund of funds” is not precisely defined at European level and needs to be clarified in order to ensure a higher

³⁷ Regulation (EU) No583/2010, recital 2.

level of harmonisation throughout the EU. The absence of a definition at European level has led to concrete issues, such as inconsistencies impacting the KIID.

Indeed, the KIID introduced by the UCITS IV directive sets specific obligations (in particular relating to the disclosure of charges) for funds that invest a “significant” portion of their assets in underlying UCITS. This might therefore lead to an inconsistent disclosure in the different Member States of the investment policy of the fund or of the charges, as they might have a different understanding of what a “significant portion” is. As a consequence, investors are not in a position to compare the KIIDs of funds of funds domiciled in different Member States.³⁸

The views expressed by this stakeholder suggest that even though an area of financial regulation seeks to achieve maximum harmonisation, differences in implementation may still arise in Member States where the specific Regulation contains insufficient harmonisation of specific areas contained in the said Regulation. This results in an unproductive outcome in terms of achieving investor protection as it has a negative impact on the comparability of specific types of UCITS such as funds of funds, particularly where these are sold across-borders within the EU. Moreover, an uneven approach to the Level 3 Guidance by CESR further damages the objective of achieving information about investment opportunities in UCITS that is consistent and comparable.

In the final analysis, deviations may compromise the effectiveness of the KIID. At the time when the Level 3 Guidance was issued by CESR in 2010, the Commission declared its intention that these should eventually be adopted in the form of technical standards drafted by ESMA. It is submitted that the Commission’s position demonstrates the extent to which internal market difficulties that may arise from uneven implementation, may trigger a process whereby soft-law is reconstituted into hard-law in order to realise the level of harmonisation necessary to achieve the investor protection that guarantees mutual recognition. This changes the nature of soft-law to almost hard-law, albeit without the official hardening having been formalised.

³⁸ THEAM (*n11*).

5.2.3 A Mechanism for Mergers

The regulation of mergers is one of the consolidation techniques stipulated in the 2009 UCITS IV Directive. Mergers in the funds industry are generally motivated by a desire to consolidate the business, achieve economies of scale and eliminate funds with poor performance.³⁹

The funds industry operates in a way wherein the average cost of a fund, such as the costs relating to the services provided by a management company, depositary and auditor, is inversely proportional to the size of the fund. The bigger the fund the lower the average cost of the service rendered to the fund. In 2007 the Commission expressed a concern that 54% of European funds managed less than €50m of assets and that the average European fund size was one fifth of that of an American fund.⁴⁰ Investors in European funds were therefore paying more than investors in American funds to maintain their investment. Through consolidation, the costs of UCITS could be reduced by €5 to €6 billion annually.⁴¹

The fragmentation in the UCITS industry was indicative of a possible failure of the internal market project to achieve an optimum level of integration in this field. The 1985 UCITS Directive did not prevent fund mergers. However, it did not address many practical obstacles that needed to be tackled in order to facilitate such mergers. Under the 1985 UCITS Directive a merger of UCITS depended on company law, contractual law, trust law and tax law set in the national legislative framework of the Member States. Relying exclusively on national law makes cross-border fund mergers difficult at best and outright impossible at worst.⁴²

Different legal techniques exist in the EU to carry out a fund merger. As a consequence achieving harmonisation while at the same time catering for the different legal traditions of Member States presented a significant challenge for the legislator. To address this

³⁹ N Jayaraman, A Khorana and E Nelling, 'An analysis of the Determinants and Shareholder Wealth Effects of Mutual Fund Mergers' (2002) 57(3) The Journal of Finance 1548.

⁴⁰ Commission, 'Initial orientations for discussion on possible adjustments to the UCITS Directive' 22.03.07 8 <<http://goo.gl/Or902C>> accessed 16.03.14.

⁴¹ Commission (n32) 6.

⁴² N Fitzpatrick, 'European Merging Markets' (2006) Global Investor.

challenge, the legislator applied a combination of minimum and maximum harmonisation provisions in order to achieve a sufficient degree of mutual recognition. This resulted in *quasi*-maximum harmonisation of regulation which allows for the necessary flexibility in order to respect the different legal traditions at national level.

The main objective of harmonisation of regulation in the field of mergers is that of achieving the degree of investor protection necessary to allow uninhibited cross-border mergers of UCITS. The framework set in the 2009 UCITS IV Directive seeks to ensure that the merger of UCITS does not prejudice the rights of investors, while at the same time allowing for the degree of flexibility with regard to merger techniques that can be applied at national level. In this regard, only those merger techniques which are most commonly applied in Member States are harmonised by the 2009 UCITS IV Directive.⁴³

To respect national differences in this field, the Directive leaves it optional for Member States to decide on the extent of application of the prescribed techniques. Nonetheless, to allow an unrestrained operation of the cross-border merger mechanism, each Member State is required to recognise a transfer of assets resulting from any one of the stipulated merger techniques.⁴⁴ Therefore, even though the merger technique applied in the Member State of the merging UCITS is not recognised as such by the law of the Member State of the receiving UCITS, the Member State of that UCITS is still required to recognise the transfer of assets which occurs as a consequence of the merger.

The three merger techniques which are harmonised by the 2009 UCITS IV Directive are the: **[i]** merger by absorption; **[ii]** merger by creation of a new fund; and **[iii]** merger by a scheme of amalgamation. The operation of mergers is subject to a number of investor protection measures which are built upon a combination of obligations requiring: **[i]** the merger to be authorised by the financial supervisor of the Member State of the merging UCITS; **[ii]** third party monitoring of the merger procedure; and **[iii]** detailed transparency with the financial supervisor and the investors in the UCITS. A combination of different degrees of harmonisation is applied to achieve the degree of investor protection which is necessary for mutual recognition in the field of mergers.

⁴³ Directive 2009/65/EC, recital 28 and article 2 (1) (p).

⁴⁴ Directive 2009/65/EC, recital 28

Financial regulation operates a mechanism of control which is largely based on a requirement for authorisation, wherein a financial supervisor verifies compliance with the applicable requirements before a particular activity may be carried out. The merger requires the approval of the financial supervisor/s of the merging UCITS and not that of the receiving UCITS because mergers generally have less of an impact on unit-holders of the receiving UCITS.⁴⁵ However, to achieve cooperation between financial supervisors, which is essential for the successful operation of the consolidation mechanisms set in the Directive, the authorisation of the merger must be carried out in close collaboration with the financial supervisor of the receiving UCITS.

The 2009 UCITS IV Directive lays down the process for the approval of the merger of UCITS. This involves the merging UCITS providing its home financial supervisor with various documents, in particular the endorsed copy of the draft terms of the proposed merger. The 2009 UCITS IV Directive stipulates the categories of information that should be included in the terms of the merger. In terms of the Directive, financial supervisors are not allowed to require additional categories of information to be included in the terms of the merger. Therefore, the requirements on the categories of information try to achieve a maximum degree of consistency on what is to be included in the terms of the merger. This aims at achieving uniformity in the categories of information irrespective of the merger technique applied. This homogeneity is important for investor protection and to achieve mutual recognition between Member States in this field.

To reinforce the level of scrutiny on the merger, the 2009 UCITS IV Directive requires the auditors or the depositary of the UCITS to make an independent valuation report on the proposed merger for consideration by the financial supervisor.⁴⁶ It is a common feature of financial regulation to allow for a certain degree of reliance on third parties for the carrying out of certain supervisory checks. A financial supervisor's resources are limited and cannot allow for close supervision of all the variables which make a financial market. Therefore, it is sensible to draw from the work of third parties that are vested with *quasi*-supervisory duties. The final responsibility for the supervisory

⁴⁵ Directive 2009/65/EC, recital 29.

⁴⁶ Directive 2009/65/EC, article 42.

function, however, remains that of the financial supervisor that must still undertake checks before granting approval.

Other significant safeguards for investor protection have also been put in place. The delicate position of retail investors that are faced with a cross-border merger merits particular consideration. For retail investors, a cross-border merger is likely to create greater ambiguities than a domestic merger, and may render access to information more difficult, thereby raising the potential information asymmetries and retail investor disadvantage. The 2009 UCITS IV Directive contains transparency requirements which seek to ensure that investors are able to make an informed judgement as to the impact of the proposed merger on their investment. The Directive stipulates detailed requirements on information to be provided to the investors of the merging UCITS and those of the receiving UCITS.⁴⁷

Transparency with investors is an area where homogeneity and consistency are coherent with the objective of achieving a high degree of investor protection across the EU which should provide investors with the necessary comfort about their rights. For this purpose, even though the relevant Level 2 measures issued in this area were adopted in the form of a Directive, the legislator tried to achieve maximum harmonisation by prohibiting financial supervisors from requiring the UCITS to include information other than that which is stipulated in terms of the detailed requirements set in the Directive.⁴⁸ This demonstrates that even where a Directive is used as the legal instrument for harmonisation, maximum harmonisation may still be accomplished.

The 2009 UCITS IV Directive prohibits the management company from charging the unit-holders for the merger. Moreover, as unit-holders might disagree with the merger, the 2009 UCITS IV Directive gives them the opportunity to redeem their units or to convert them into units of another UCITS with similar investment policies.⁴⁹ The granting of this essential investor protection option could raise operational difficulties for the merging UCITS. Where investors are given the opportunity to redeem their holding, UCITS with an average performance are likely to lose approximately 25% of

⁴⁷ Directive 2009/65/EC, article 43 and Commission Directive 2010/44/EU.

⁴⁸ Directive 2010/44/EU, recital 2.

⁴⁹ Directive 2009/65/EC, recital 30 and article 45.

unit-holders.⁵⁰ This reality may distort the full potential of mergers as a tool to achieve consolidation. It is however necessary if the investor protection objective is to be respected.

The framework for the merger of UCITS based on *quasi*-maximum harmonisation requirements is justified given the national differences that exist with regard to merger techniques set in the legislative framework of the different Member States and should allow for the degree of mutual recognition which is required to facilitate the application of cross-border mergers of UCITS. However, achieving the right balance of harmonised and national regulation is not the only determinant for unobstructed cross-border mergers of UCITS. Given the involvement of financial supervisors in different Member States for the execution of cross-border mergers, implementing a cross-border merger agenda also depends on adequate supervisory convergence.

The 2009 UCITS IV Directive contains detailed provisions on cooperation amongst financial supervisors including provisions in the field of mergers. However, empirical research carried out for the purpose of the thesis suggests that the convergence of supervisory practices in the field of investment management in the EU, and particularly in the field of UCITS, remains weak.⁵¹ Different practices apply in Member States with regard to reporting requirements, as well as in the type and extent of checks that are carried out by financial supervisors when granting an authorisation, including authorisations in respect of mergers. In particular where the execution of the merger requires the formation of a new UCITS, since the requirements on the authorisation, constitution and functioning of UCITS set in the 2009 UCITS IV Directive are based on minimum harmonisation type regulation.⁵² This may result in regulatory and supervisory arbitrage and could have an impact on the functioning of the framework for cross-border mergers.

The minimal degree of harmonisation of the regulation of the authorisation, constitution and functioning of UCITS and the lack of supervisory convergence in the field of investment management are limitations of the regulatory mechanism for mutual

⁵⁰ StateStreet (*n1*).

⁵¹ ESMA, 'Peer Review – MMF Guidelines' 15.04.13 (ESMA/2013/476) <<http://goo.gl/ISbWcl>> accessed 16.03.14.

⁵² Directive 2009/65/EC, article 5.

recognition under the 2009 UCITS IV Directive. They also have an impact on the other consolidation mechanisms set in the Directive.

5.2.4 Master-Feeder Structures

Fund mergers are not the only route to achieve consolidation. This is not the preferred choice in cases where the appeal of a UCITS to investors depends on the extent to which it caters for their specific needs in the Member State in which the investor is located. In this respect, it is argued that master-feeder structures become the most viable option to achieve consolidation.⁵³

A feeder fund invests 85% or more of the monies of investors into a master fund, which in turn invests its assets according to the investment objectives, policies and restrictions set in its prospectus. Master-feeder structures allow management companies to attain the economies of scale and cost efficiencies that may be derived from larger pools of assets through the use of a master fund. They also give management companies the opportunity to create dedicated feeder funds that satisfy the requirements of the domestic market they are meant to target.⁵⁴

The failure of the negotiations of the 1993 UCITS II proposal, which proposed the formation of cross-border master-feeder structures based on minimum harmonisation of regulation, suggested that a higher degree of harmonisation of investor protection regulation would be required if this consolidation mechanism was to be allowed to operate in the EU. As in the case of the regulation of cross-border mergers, the EU institutions employed the *quasi*-maximum harmonisation technique whereby minimum harmonisation was combined with maximum harmonisation in the same field of regulation.

The aim of substantive regulation in this field continues to be that of achieving a sufficient degree of harmonisation of investor protection regulation which allows mutual recognition between the Member States. This form of regulation aims at

⁵³ Commission (n40) 2.

⁵⁴ C MacManus, 'Fresh food for growing appetites—Master-Feeder UCITS' (2010) 42(3) Accountancy Ireland 36.

facilitating the effective operation of the internal market by ensuring a sufficient degree of homogeneous investor protection throughout the EU.⁵⁵ The investor protection requirements follow the same pattern as those stipulated in the context of cross-border mergers of UCITS. These stipulate requirements on: **[i]** authorisation applicable to master-feeder structures; **[ii]** third party monitoring; and **[iii]** transparency with investors and the dis-application of charges.

The 2009 UCITS IV Directive requires the master-feeder structure to be approved by the financial supervisor of the feeder UCITS. For this purpose the fund documentation, the agreements establishing the master-feeder structure and the information to investors must be submitted for the relevant financial supervisors' consideration. In order to ensure proper supervisory cooperation, the 2009 UCITS IV Directive stipulates that where a feeder UCITS is established in a Member State other than that of the master UCITS, the feeder UCITS should provide its financial supervisor with an attestation from the financial supervisor of the master UCITS that this complies with the requirements of the Directive.⁵⁶

The degree of harmonisation achieved in the 2009 UCITS IV Directive with regard to the conditions that must be met and the documents and information that are to be provided to the relevant financial supervisors in the context of the approval of a master-feeder structure is meant to be exhaustive.⁵⁷ As in the case of the mechanism for mergers, although the Level 2 measures in the field of master-feeder structures were adopted in the form of a Directive, the relevant conditions still seek to realise maximum harmonisation of regulation. Therefore, in approving the structure the financial supervisor is only allowed to verify compliance with the requirements of the 2009 UCITS IV Directive and is not permitted to require any additional conditions to be met by the UCITS.

To ensure the proper functioning of the relationship between the feeder UCITS and the master UCITS, a formal agreement must be endorsed by the UCITS outlining the terms

⁵⁵ Directive 2009/65/EC, recital 52.

⁵⁶ Directive 2009/65/EC, article 59.

⁵⁷ Directive 2009/65/EC, recital 52.

of the relationship.⁵⁸ The regulation of the categories of information to be included in the formal agreements is another example of maximum harmonisation, as the 2009 UCITS IV Directive prohibits Member States from requiring the formal agreement to cover elements other than those stipulated in the Directive.⁵⁹ However, where the feeder UCITS and the master UCITS have the same manager, a formal agreement is not required and the arrangements between these UCITS may be drawn up in internal conduct of business arrangements.⁶⁰ This simplified approach to the formalisation of an established *modus operandi* is a good example of the application of the principle of proportionality in the 2009 UCITS IV Directive. It would have been unnecessary over-regulation had the Directive required a feeder UCITS and a master UCITS which are managed by the same entity to enter into a formal agreement, as this generally deals with matters which fall within the responsibility of the management company.

To further strengthen the investor protection framework with regard to master-feeder structures, the 2009 UCITS IV Directive requires the establishment of an information sharing agreement between the depositary of the feeder UCITS and that of the master UCITS.⁶¹ This requirement applies where the feeder UCITS and the master UCITS have different depositaries. The same requirement also applies with regard to the auditors of feeder UCITS and master UCITS.⁶² The categories of information that should be included in the agreements are harmonised by the 2009 UCITS IV Directive.

At the time when the 2009 UCITS IV Directive was adopted, harmonisation of the regulation of depositaries was still at a minimum level. In view of the difference in the approach to the regulation of depositaries at national level, a certain degree of flexibility is allowed in relation to the content of the agreement on exchange of information between depositaries. This is an example where the legislator exercised special care not to harmonise to the extent that the depositary could be required to carry out tasks that are forbidden or not provided for under the national law of their home Member State.⁶³ At the same time, however, the degree of harmonisation achieved ensures that there is a

⁵⁸ Directive 2009/65/EC, article 60(1); Directive 2010/42/EU, article 10.

⁵⁹ Directive 2010/42/EU, recital 7.

⁶⁰ Directive 2009/65/EC, article 60; Directive 2010/42/EU, chapter III, section I, subsection III.

⁶¹ Directive 2009/65/EC, article 61; Directive 2010/44/EU, Chapter III, Section 3, Sub-section 1.

⁶² Directive 2009/65/EC, article 62; Directive 2010/44/EU, Chapter III, Section 3, Sub-section 2.

⁶³ Directive 2010/44/EC, recital 15.

proper flow of a minimum amount of information and documentation that is required by the feeder UCITS' depositary so as to be in a position to fulfil its duties.⁶⁴

In order to achieve a high degree of investor protection, the 2009 UCITS IV Directive also contains specific requirements stipulating transparency with investors.⁶⁵ The prospectus issued in relation to a feeder UCITS must contain specific reference to the fact that the UCITS is a feeder UCITS of a particular master UCITS. This should also include a description of the master UCITS and an indication of how the prospectus of the master UCITS may be obtained.⁶⁶ In this way, the prospective investor in the feeder UCITS is informed about the nature and complexity of the investment and has the opportunity to obtain detailed information on the master UCITS.

Asymmetric information is not the only investor protection concern that arises from master-feeder structures. Applying unwarranted fees to investors may become one of the features of these structures.⁶⁷ In order to ensure that investors are not subject to unjustified charges, the 2009 UCITS IV Directive prohibits the master UCITS from charging feeder UCITS subscription⁶⁸ and redemption fees.⁶⁹ This should avoid the double application of fees to investors first at the level of the feeder UCITS and eventually at the level of the master UCITS. It also suggests the legislators' concern about the use of master-feeder structures to generate unjustified income for management companies.

One may argue that the 2009 UCITS IV Directive creates a suitable regulatory environment which should allow a sufficient degree of mutual recognition in the field of master-feeder structures.⁷⁰ However, as in the case of the regulation of cross-border mergers, the effectiveness of master-feeder structures in achieving an optimal degree of

⁶⁴ Directive 2010/44/EC, article 24.

⁶⁵ Directive 2009/65/EC, recital 54.

⁶⁶ Directive 2009/65/EC, article 63.

⁶⁷ T Duong and F Mesche, 'The Rise and Fall of Portfolio Pumping Among US Mutual Funds' (2009) <www.ssrn.com> accessed 04.06.11.

⁶⁸ Investors are charged subscription fees each time an investment is made in a UCITS and redemption fees when they redeem their investment.

⁶⁹ Directive 2009/65/EC, article 66 (2).

⁷⁰ K Baillie, 'UCITS Master/Feeder Structures', (2011) FieldFisherWaterhouse <<http://goo.gl/CwPYhS>> accessed 04.06.11.

consolidation will depend on the extent to which financial supervisors will facilitate the operation of these structures on a cross-border basis through supervisory convergence.

Given the extensive supervisory cooperation mechanisms, which are provided for in the 2009 UCITS IV Directive, in particular the attestation mechanism mentioned above, cooperation amongst financial supervisors in this field is encouraged. However, different regulatory conditions and supervisory approaches exist with regard to the authorisation of a new UCITS and the on-going regulation and supervision of the constitution and functioning of the UCITS, particularly as this is an area which was not adjusted as part of the revision of the Directive and remains entirely based on minimum harmonisation of regulation.⁷¹

Moreover, as already examined in the previous section, the on-going supervision of UCITS, is an area where different practices exist and where minimal convergence, if any, has been achieved. The relevant supervisory processes vary between financial supervisors to a significant extent. For instance, as part of the authorisation procedure some financial supervisors endorse some or all of the UCITS documentation while others mainly depend on *ex-post* supervision of documentation on a sample basis.⁷² The uneven approach to regulation and supervision creates opportunities for regulatory and supervisory arbitrage, which result in mutual distrust between financial supervisors, and generate uncertainty that may disrupt the formation of cross-border activity including the operation of cross-border master-feeder structures.

5.2.5 Management Company Passport

The 2001 UCITS III Directive was the first attempt to establish a mechanism for mutual recognition which would allow cross-border management of UCITS. However, at implementation stage, national financial supervisors were of the view that management companies should not be allowed to provide collective portfolio management on a cross-border basis as splitting financial supervision between the UCITS and the depositary on the one hand, and the management company on the other, would have

⁷¹ Directive 2009/65/EC, article 5.

⁷² ESMA (n51).

weakened investor protection.⁷³ Financial supervisors were not yet prepared to accept mutual recognition with regard to the provision of collective portfolio management and as a consequence they collectively agreed that UCITS would only be allowed to designate a management company established in the same Member State and therefore subject to supervision by the same national financial supervisor.⁷⁴

The supervisory restriction to the provision of collective portfolio management on a cross-border basis went against the fundamental freedoms provided in the Treaty and the 2001 UCITS III Directive. Evidence on the benefits of a management company passport, gathered during discussions and consultations with stakeholders on the future of investment management in the EU, led the Commission to consider a fresh initiative in this field. An effective management company passport was another element of a package of mechanisms to be introduced in the UCITS Directive with the primary aim of bringing about more efficiency through consolidation.⁷⁵

The adoption of a new proposal for an effective management company passport proved to be a rough road to ride as not all stakeholders were in favour of this proposal. The industry in Luxembourg and Ireland were adamant that the best way forward for the UCITS Directive was that of remaining a product based legislative framework focused on creating an internal market for UCITS rather than extending the benefits of the internal market to management companies.⁷⁶ In the context of the examination of the conditions for mutual recognition, it is relevant to refer to the main argument made against the introduction of the management company passport and the conditions that in the end made its adoption achievable.

⁷³ C Kremer and T Seale, 'Passport benefits may not be worth risk' *Financial Times* (London 13 October 2008) <www.ft.com> accessed 13.02.11.

⁷⁴ CESR, 'Guidelines for supervisors regarding the transitional provisions of the amending UCITS Directives (2001/107/EC and 2001/108/EC)', (2005) CESR/04-434b; K Lannoo, 'Regulatory Challenges for the EU Asset Management Industry' (2010) ECMI Policy Brief 3; and C Niedner and A Sawires, 'Passport Flexibility' (2010) 96 *European Lawyer* 45.

⁷⁵ J Quinn, 'The Management Company Passport: A New Era of Cross Border UCITS' (2011) *Cork Online Law Review* <www.corkonlinelawreview.com> accessed 31.05.11.

⁷⁶ ALFI, 'ALFI contribution to the CESR consultation paper on UCITS management company passport' 15.10.08 <www.alfi.lu> accessed 11.06.11; also refer to *Financial Times*, 'UCITS IV plan could be dropped' *Financial Times* (London 14.04.08) <www.ft.com> accessed 13.02.11 and 'Brussels drops pan-Europe funds plan' *Financial Times* (London 24.05.08) <www.ft.com> accessed 13.02.11.

The anti-passport movement submitted the general argument that proximity allows for comprehensive financial regulation and supervision and that a management company passport would make it more difficult for financial supervisors and the depositary to fulfil their monitoring duties.⁷⁷ Fragmentation of regulation and supervision of a UCITS structure into different parts would have an impact on the overall robustness of the regulatory framework and supervisory processes of UCITS. This split could, as a consequence, have an impact on investor protection and result in a loss of investor confidence in the UCITS brand.⁷⁸

These arguments could not be ignored. Consequently, the Commission took the prudent approach of leaving out this key development from its 2008 Proposal for a recast Directive.⁷⁹ The Commission requested CESR's advice on the supervisory and technical conditions that had to be in place to allow mutual recognition to operate in the field of fund management i.e. the conditions that are needed to ensure that a management company passport is consistent with the principle that investors in funds that are managed on a cross-border basis should not be exposed to additional legal and operational risks, or lower standards of supervision than investors in domestically managed UCITS.⁸⁰ CESR provided the Commission with a solution which sought to resolve the apparent mutual distrust between financial supervisors by proposing a clear separation of regulatory and supervisory responsibilities between the home and host Member State of the management company. CESR also recommended the implementation of a set of measures that would ensure that the home and host financial supervisors would have sufficient powers and information to discharge their duties effectively.⁸¹

In order to resolve concerns about fragmented supervision, CESR's advice went into great length in describing the cooperation arrangements that should be in place between the home and the host financial supervisor. It also recommended that these should have

⁷⁷ Commission (n40) 5.

⁷⁸ Kremer et al (n73) 1.

⁷⁹ Commission, 'Commission proposes improved EU framework for investment funds', IP/08/1161, 16.07.08 2 <<http://goo.gl/3pmrbf>>accessed 16.03.14.

⁸⁰ Commission, 'Request for assistance: UCITS Management Company Passport' MARKT/G4/PS/D(2008), 16.07.08<<http://goo.gl/c5Kou9>>accessed 16.03.14.

⁸¹ CESR, 'Advice to the Commission: UCITS Management Company Passport' CESR08-867, October 2008<<http://goo.gl/bvWyNY>>accessed 16.03.14.

the power and should be encouraged to conclude bilateral or multilateral cooperation agreements that could also include the formation of cross-border colleges of financial supervisors. CESR's advice exemplifies the flexibility of existing governance mechanisms for financial supervision, such as the M.O.U. and the formation of colleges of financial supervisors and how these, together with new mechanisms such as delegation of supervisory tasks, may be applied in different fields of financial supervision in order to seek to address difficulties arising from potential mutual distrust.

Nonetheless, during the discussions at CESR the financial supervisors of five Member States objected to the proposals as they remained of the view that applying a management company passport would not have permitted the financial supervisors of the UCITS to perform their duties effectively.⁸² The same dissenting views were also expressed by a number of Member States during the negotiations in Council.⁸³ This position *inter alia* points towards a lack of confidence in the tools for supervisory cooperation and convergence as a means to overcome supervisory difficulties that arise from cross-border structures.

At the end of the process, the management company passport was adopted on the basis of a regulatory framework which, by and large, reflected CESR's advice. The EU institutions were cautious and did not make significant alterations to CESR's proposal as these would have tilted the well-thought supervisory balance between the home and the host financial supervisor. This supervisory balance was deemed essential to allow the management company passport to work.

The formula for the functioning of the management company passport was based on a split of the regulation and the supervision of activity of the management company between the home and the host Member State, sustained by detailed requirements on cooperation and exchange of information between the relevant financial supervisors. The regulatory framework contains three categories of substantive requirements which must be complied with by a management company: [i] authorisation requirements

⁸² CESR, 'Covering letter: Advice to the Commission on the UCITS Management Company Passport' CESR08-067 31.10.08<<http://goo.gl/bvWyNY>>accessed 16.03.14.

⁸³ 2952 meeting of the Council, 15.07.09

which must be satisfied by an applicant at licensing stage⁸⁴; **[ii]** on-going obligations in the form of organisational requirements⁸⁵, conduct of business requirements⁸⁶ and prudential requirements⁸⁷; and **[iii]** rules applicable to the constitution and functioning of the UCITS⁸⁸.

The degree of harmonisation achieved for the purpose of the requirements applicable to the management company is a mixture of minimum harmonisation requirements and maximum harmonisation requirements, thereby achieving *quasi*-maximum harmonisation. Minimum harmonisation is the technique applied in fields such as the authorisation requirements, prudential requirements, the rules on reporting and the prospectus where the Member States are allowed to establish stricter rules than those stipulated in the 2009 UCITS IV Directive.⁸⁹ On the other hand, the extent of harmonisation achieved particularly through Level 2⁹⁰ measures with regard to the organisational and conduct of business requirements lean towards maximum harmonisation.

The extent of harmonisation of the organisational and conduct of business requirements suggest that the EU institutions were more concerned about the impact of potential regulatory arbitrage from significant differences in these fields of regulation rather than in others. The high degree of harmonisation sought is also indicative of their significance in fostering confidence among financial supervisors and thereby allowing mutual recognition to work. The nature of conduct of business rules applicable to a management company makes proximity of supervision essential and therefore the host Member State is directly involved in the monitoring of their compliance. Therefore, since the conduct of business requirements of a host Member State would apply to a passporting management company, a high degree of harmonisation of this form of regulation was also important in order to limit duplication of the same category of procedures or functions by management companies, thus avoiding additional barriers to cross-border activity.

⁸⁴ Directive 2009/65/EC, articles 6, 7 and 8.

⁸⁵ Directive 2009/65/EC, article 10.

⁸⁶ Directive 2009/65/EC, article 14.

⁸⁷ Directive 2009/65/EC, articles 7 and 12.

⁸⁸ Directive 2009/65/EC, articles 19 (3).

⁸⁹ Directive 2009/65/EC, recital 15.

⁹⁰ Directive 2010/43/EU.

The conduct of business requirements are not the only rules which fall within the competence of the host Member State where a management company exercises the passport. The rules applicable to the constitution and functioning of the UCITS are also fields of law where the competence for regulation and supervision remains that of the host Member State.⁹¹ CESR argued that this competence should be left within the remit of the host Member State as the risks governing the constitution and the functioning of the UCITS should remain the same irrespective of whether this is managed by a domestic management company or a by a passporting management company.⁹²

Split supervision is an area which presents difficulties to the operation of the passport as a management company will be subject to different requirements on the constitution and functioning of the UCITS in each separate Member State where it passports to provide services to a UCITS. Moreover, within the context of strengthening the internal market, one may also argue that the protection of European investors would have been improved had CESR taken the view that the requirements on the constitution and the functioning of UCITS had to be harmonised across the EU.

While in the context of creating an effective internal market the EU harmonisation of substantive law is fundamental, its long term success or failure largely depends on the governance mechanism for the supervision of its application in practice.⁹³ It is evident that it is not possible to monitor a UCITS cross-border structure effectively unless the whole of its operation can be supervised in a coordinated manner. Indeed, after more than two years from the date of applicability of the 2009 UCITS IV Directive, there are relatively few examples of the use of the management company passport as *inter alia* the current fragmented supervisory framework is proving to be too difficult to operate effectively in practice.⁹⁴

⁹¹ Directive 2009/65/EU, article 19.

⁹² CESR (*n81*).

⁹³ V Conti, 'Rethinking Regulation and Oversight to Learn the Lessons from the Crisis' Paolo Baffi Centre Paper No.2011-106 19<www.ssrn.com>accessed 12.10.12.

⁹⁴ ALFI, 'Reply to the Commission Consultation on UCITS' October 2012 13<<http://goo.gl/e5X48E>> accessed 16.03.14.

5.2.6 Fragmented Financial Supervision: The Heart of the Matter

The supervision of a UCITS is governed by the home-host country principles. The home-host financial supervisors are required to interact and cooperate for the better supervision of the UCITS structure, which comprises a UCITS, the management company and the depositary.⁹⁵ The extent of interaction between the home-host financial supervisors and the possible combinations of financial supervisors from different Member States having a share in the supervisory arrangement for a UCITS structure, may vary depending on whether the structure is entirely a national structure where the UCITS and the management company are established in the same Member State or a cross-border structure where the UCITS and the management company are established in different Member States. In the case of the former the interaction is limited and mainly takes place when the UCITS makes a passporting notification to the home Member State, which in turn must transmit that information to the host Member State.⁹⁶

Where the UCITS and the management company are established in the same Member State, the main point of contact for the entire UCITS structure would be the home financial supervisor, with the host financial supervisor responsible for compliance with national marketing rules and the power to take regulatory action against the passporting UCITS in case of infringement.⁹⁷ Where the UCITS and the management company are established in different Member States, in addition to the supervision of the UCITS structure by the home-host financial supervisors and the interaction among them, the governance mechanism for the supervision of the UCITS is stepped up by an additional layer of financial supervisors, namely the home-host financial supervisors of the management company.⁹⁸ When the management company passports collective portfolio management in a host Member State, the arrangements for its supervision are effectively split between the home financial supervisor and the host financial supervisor.

In the field of investment management, national financial supervisors still apply purely national supervisory philosophies and methods for monitoring compliance with the

⁹⁵ Directive 2009/65/EC, article 101.

⁹⁶ Directive 2009/65/EC, article 93.

⁹⁷ Directive 2009/65/EC, article 93, 94 and 108.

⁹⁸ Directive 2009/65/EC, article 109.

requirements applicable to UCITS and their service providers, including management companies. In broad terms a certain degree of linearity exists in the methods applied for supervision. Indeed, generally speaking, financial supervisors carry out their supervisory duties through a mixture of authorisation procedures and off-site and on-site compliance monitoring of the activity of financial institutions. Albeit, empirical research carried out for the purpose of the thesis has shown that the scope and frequency of specific methods of supervision and the extent of checks carried out vary significantly between different financial supervisors.⁹⁹

With regard to the methodology adopted for determining the intensity of supervision, it has to be pointed out that while the financial supervisor in the UK and the Netherlands have been applying a risk-based approach to supervision for the last decade, it is only recently that financial supervisors in Member States, such as Ireland, have implemented this methodology for the supervision of their financial industry.¹⁰⁰

In the field of the supervision of investment management a risk-based approach means that supervision focuses mainly on those entities where failure could do the greatest damage.¹⁰¹ However, risk based supervision is not an approach that is favoured by all national financial supervisors.¹⁰² In Member States, such as in Italy, Malta and Spain, a full-compliance monitoring based approach to supervision is applied irrespective of the type and potential impact of the failure of the particular financial institution.¹⁰³

Moreover, significant differences exist with regard to the regular reporting requirements applicable to UCITS and management companies and the type of checks which are carried out as part of the off-site review and those carried out during an on-site compliance inspection. With regard to the reporting requirements, an analysis of the

⁹⁹ Interviews carried out for the purpose of the thesis. For further information, see the methodology section in chapter 1 and annexes 1 and 2.

¹⁰⁰ M Elderfield, 'PRISM – risk based supervision in Ireland' Address to the Association of Chartered Certified Accountants (Dublin 01.12.11) <www.bis.org> accessed 12.10.12.

¹⁰¹ G Murphy, 'Address to the Irish Funds Association' (Dublin 02.06.11) <www.financialregulator.ie> accessed 12.10.12.

¹⁰² E Ferran, 'Principles-based, risk-based regulation and effective enforcement' in M Tison and others, *Perspectives in Company Law and Financial Regulation* (Cambridge University, 2009) 446.

¹⁰³ C Buttigieg and M Chetcuti, 'Regulation of Funds in Malta: The Challenges Ahead', (2013) 21(2) *Journal of Financial Regulation and Compliance* 121-135. Also relevant is the information obtained during the interviews carried out for the purpose of the thesis. For further information, see the methodology section in chapter 1 and annexes 1 and 2.

applicable regulation in different Member States indicates that in addition to the annual and half-yearly financial statements which a UCITS is required to submit to its national financial supervisor, a number of Member States require UCITS to submit quarterly, monthly or daily reports including reports on the portfolio of assets held by the UCITS.¹⁰⁴

Another significant difference is found in the approach to supervision in the field of investment management. The Anglo-Saxon approach focuses primarily on the conduct of business and the processes of the management company while the Continental approach also gives due consideration to the authorisation and supervision of the fund.¹⁰⁵

The differences in the philosophies and the methods of supervision are significant and may result in supervisory arbitrage particularly where a UCITS or management company exercises the passport.¹⁰⁶ These differences may exacerbate the negative impact of split supervision on the functioning of the management company passport, as a result of which the cost of exercising the passport could prove to be more significant than the benefits given the different regimes with which a management company would be required to comply whenever it exercises the passport. The fact that the management company passport has hardly ever been exercised so far is indicative of this potential barrier.

The combination of financial supervisors involved in the supervision of a UCITS structure may become significant. By way of example with regard to a UCITS cross-border structure in its simplest form, whereby a UCITS is established in Member State A, has passported to market its units in Member State B and C and has engaged a management company in Member State D, which has in turn passported in Member State A in order to be in a position to provide collective portfolio management services to the UCITS, the financial supervisors of the four different Member States would be involved in the supervision of the UCITS cross-border structure. The main difference

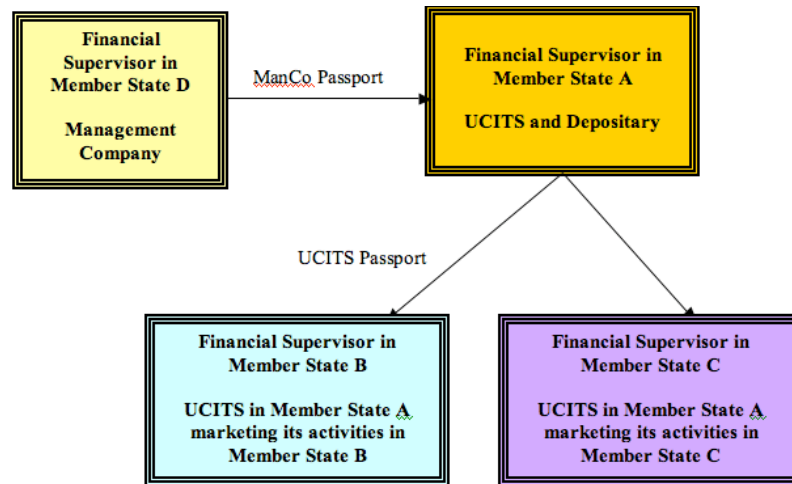
¹⁰⁴ ESMA (n51).

¹⁰⁵ H Davies, 'Creating a Single Financial Market in Europe: What do we mean?' FMG Lecture 03.02.04 <<http://eprints.lse.ac.uk/28908/>> accessed 12.10.12.

¹⁰⁶ Commission, 'Impact Assessment: Proposal for a Directive on AIFM' SEC[2009]576 30.04.09 <http://goo.gl/zTt1ej> accessed 16.03.14.

between them would be the extent of supervision, with the financial supervisors in Member States A and D being most active in the supervisory process.

Diagram 5.1 – Financial Supervisors involved in a UCITS Cross-Border Structure



The supervision of cross-border structures suggests that a governance mechanism based on fragmented supervision may give rise to various difficulties. It is likely to result in fragmented information being provided to the different national financial supervisors who are involved in the arrangements for supervision of the cross-border UCITS structure and in different reporting formats required by each individual national financial supervisor. On the one hand, this increases the administrative burden on the UCITS cross-border structure, while on the other hand it reduces the possibility of timely action where serious investor protection issues or other infringements of the Directive arise. If the relevant national financial supervisors work without engaging in collegial supervision, there is the additional risk that the said structure may be subject to insufficient and therefore less effective supervision. Within the context of the internal market, an uneven and fragmented approach to supervision may generate delays and inefficiencies and may subtly be operated as a tool for competition between established financial jurisdictions.

Divergent and fragmented supervision provides incentives to national financial supervisors to compete via lax supervisory standards and practices. Indeed, it has been

argued that in the largely neo-liberal world that existed prior to the financial crisis, Member States avoided filling in the regulatory and supervisory gaps for competition reasons.¹⁰⁷ This state of affairs has, by and large, remained unchanged. Today special attention is still exercised in order to avoid putting national industry in a less competitive position or out of concern that some financial institutions might decide to move part of their business to a less strict supervisory system.¹⁰⁸ Moreover, the plurality of financial supervisors operating in the Member States can paradoxically increase gaps in oversight, which situation makes crises prevention harder.¹⁰⁹

Supervisory arbitrage undermines mutual trust between national financial supervisors and may threaten financial market stability.¹¹⁰ For the internal market to operate properly, the host financial supervisor must be comfortable with the supervisory practices of the home financial supervisor. Therefore, unless Member States deal with financial supervision in a way that is satisfactory to their peers, when a financial crisis emerges, the resulting problem will become an issue of blame rather than of resolution at minimum cost.¹¹¹ It follows that while a certain degree of divergence in approach will always remain in view of cultural specificities, a convergent approach is necessary with regard to the core principles of financial supervision.

In the field of UCITS, a fragmented and divergent supervisory environment does not allow a full cross-border UCITS structure to operate effectively as it raises significant concerns over coordination of financial supervision.¹¹² Such supervisory environment

¹⁰⁷ D Pesendorfer, 'Goodbye neo-liberalism? Contested policy responses to uncertain consequences of the 2007-2009 financial crisis' in K Alexander and R Dhumale, *Research Handbook on International Financial Regulation* (Edward Elgar 2012) 414-434.

¹⁰⁸ D Schafer, 'Chinese Banks Flee London's Tough Rules' *Financial Times* (London, 28.10.12) <www.ft.com> accessed 13.01.12.

¹⁰⁹ D Masciandaro, 'Reforming Regulation and Supervision in Europe: Five Missing Lessons from the Financial Crisis' Paolo Baffi Centre Paper No.2011-89 April 2011 <www.ssrn.com> accessed 12.10.12.

¹¹⁰ See amongst others: J Krol, 'Towards a new supervisory architecture in Europe' (Speech, Brussels) 07.05.09 <<http://goo.gl/LXQU6f>> accessed 12.10.12; N Dorn, 'Rendering unto Caesar: EU financial market regulation meets political accountability' (2011) *Journal of European Integration*, 205-221; Comments by the Deputy Director of the EFAMA on mutual trust between financial supervisors in B Aboulain 'Call for clarification, not review, of UCITS' *Financial Times* (London 07.10.12) <www.ft.com> accessed 20.10.12.

¹¹¹ D Mayes, 'Some rules for cross-border banks in Europe' in K Alexander and R Dhumale, *Research Handbook on International Financial Regulation* (Edward Elgar 2012) 133-147.

¹¹² See amongst others EFAMA, 'Reply to Commission consultation paper on the UCITS Depositary Function and the UCITS Managers' remuneration' 31.01.11 <www.efama.org>; EBF, 'Response to the Commission's consultation on UCITS VI' 18.10.12 <www.ebf-fbe.eu>; ALFI, 'Reply to the Commission Consultation Document on UCITS' October 2012 12-15 <www.alfi.lu/> accessed on 20.10.12.

would not give the required comfort to the Member States to accept the level of mutual recognition of supervisory practices which is necessary for rendering a depositary passport acceptable, which passport happens to be the missing link within the chain that would establish a full cross-border UCITS structure.

The regulatory framework applicable to depositaries is in the process of being updated through the 2012 UCITS V Proposal¹¹³, which seeks to achieve *quasi*-maximum harmonisation with regard to the eligibility criteria for depositaries, their duties and responsibilities and the extent of their liability towards investors, so as to ensure a higher degree of investor protection in the field of UCITS. Article 49 TFEU requires that restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Article 56 TFEU requires that restrictions on freedom to provide services within the Union shall be prohibited in respect of nationals of Member States who are established in a Member State other than that of the person for whom the services are intended. While the existing restriction on the freedom to provide depositary services may be justified on the basis of lack of harmonisation of the regulatory framework applicable to such entities, the eventual implementation of the 2012 UCITS V Proposal is most likely to leave little scope for divergent national laws across the Member States in the field of depositary requirements. Therefore, on the premise that harmonisation of regulation that has the purpose of ensuring homogenous investor protection is a necessary condition for mutual recognition between Member States and thereby giving access to the internal market, one may argue that a depositary passport should be the resulting benefit from a process of harmonisation of regulation in this field.

The implementation of the proposed strict liability requirements together with the significant onus put on depositaries with regard to their duties, are likely to result in considerable costs for the depositary industry.¹¹⁴ While the significant revision to the regulatory framework applicable to depositaries, which has largely remained unaltered since the 1985 UCITS Directive, is a necessary step to address the lessons of the Madoff

¹¹³ Commission, 'Proposal for a Directive amending Directive 2009/65/EC as regards, depositary functions, remuneration and sanctions' COM(2012)350<<http://goo.gl/bvWJxi>>; On 25.02.14 the Greek Presidency reached political agreement with the European Parliament on UCITS V Directive <<http://goo.gl/3U8vcQ>>accessed 28.02.14.

¹¹⁴ Ernst&Young, 'AIFMD: get ready for European depositary reform' March 2012<www.ey.com>accessed 20.12.12.

scandal¹¹⁵, the costs involved with regards to implementation will most likely lead to consolidation within the industry and a reduction in competition. In order to remain a viable business activity and to benefit from economies of scale, it is expected that small-medium sized players will have to join forces or cease to provide depositary services altogether. As a consequence of possible consolidation, one may reasonably predict that only a few depositaries will remain active in Europe, namely the ten global custodian banks¹¹⁶ which however are not present in all Member States.

Consolidation may have the unintended consequence of decreasing the depositary capacity in those Member States where the industry is still in its infancy. This could lead to monopolistic behaviour and consequently a significant increase in the direct expense of engaging a depositary. Therefore, consolidation may result in the creation of an unfair level playing field for those UCITS established in Member States with an undeveloped depositary industry. If consolidation and lack of competition turn out to be the inevitable accidental results of additional harmonised regulation, providing depositaries with access to the internal market through the adoption of a depositary passport becomes the inevitable solution to ensure a level playing field within the internal market.

One may argue that a depositary passport could generate a certain degree of competition within the industry and consequently a higher degree of efficiency. It could also provide UCITS that are already established in jurisdictions where there is limited depositary capacity with a route to continue to operate in the Member States where they are currently established. Given the essential role of a depositary for investor protection, it is critical for the home financial supervisor of the UCITS to have immediate and instant access to the depositary.¹¹⁷ Particularly in order to ensure the proper performance of its obligations, thus guaranteeing the adequate safekeeping of the investors' assets. Moreover, in times of crisis the home financial supervisor of the UCITS might even decide to secure the assets of the UCITS, which are held by the depositary.

¹¹⁵ P Skypala, 'UCITS victory soured by Madoff scandal' *Financial Times* (London, 19.06.09) 6.

¹¹⁶ Commission, 'Impact Assessment: Proposal for a Directive amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to UCITS as regards depositary functions, remuneration policies and sanctions, COM(2012)350 12<<http://goo.gl/bvWJxi>>accessed 16.03.14.

¹¹⁷ See the replies to the Commission's 2012 UCITS VI consultation, in particular that of financial supervisors<<http://goo.gl/Kh0JCy>>accessed 18.05.13.

The point has been made that a depositary passport would significantly reduce the home financial supervisor of the UCITS' access to the depositary. It may also complicate the supervision of a cross-border UCITS structure by introducing an additional layer of fragmented supervision, as the home financial supervisor of the UCITS and the management company would want to participate in the arrangements for the supervision of the depositary. Supervisory fragmentation and inefficiencies aggravate the barriers to the realisation of the full potential of the internal market project for UCITS. This sustains the position that the practical impact of harmonised regulation may not be effective unless there is a convergent approach to the way it is applied, supervised and enforced by national financial supervisors.

In a recent speech, the ESMA Chairman, Dr Steven Maijoor, raised the concern that supervisory convergence was proving difficult to achieve and that the mechanisms to reach this objective should therefore be re-evaluated. He specifically stated the following:

Why has progress been more difficult in the area of supervisory convergence? ... while I think the governance of the ESAs works quite well for the single rule book and direct supervision, it is not surprising there are more tensions in the convergence area as it requires judging the supervisory practices of one or more colleagues in the Board. Hence, I think we should reconsider the organisation and governance of our convergence work and how we can improve the tools available to the ESAs in this area.¹¹⁸

The comments made by Dr Maijoor, suggest that the supervisory convergence problem is in the system itself. Practical experience suggests that the European Authorities, including ESMA, are perceived by national financial supervisors as pushing convergence from the top, by way of a command and control approach where practices

¹¹⁸ S Maijoor, 'ESAs–Achievement and Challenges' ESMA/2013/603, 24.05.13<<http://goo.gl/rkdeRj>> accessed 16.03.14.

are selected and imposed by EU bureaucrats, with insufficient debate having occurred between national financial supervisors.¹¹⁹

By way of example, in the field of CRD¹²⁰ where a process of supervisory convergence is currently being steered by the EBA, no degree of proportionality has been applied in the drafting of the templates for reporting of financial resources, which national financial supervisors will be required to apply to financial institutions locally. While the aim of these templates is that of achieving supervisory convergence, they are creating tensions between the European Authorities and national financial supervisors, as they fail to take into account the differences that exist in local markets, particularly the size of the institutions that operate in the different Member States. EBA is forcing this framework for convergence, notwithstanding the pleas of national financial supervisors particularly those coming from small Member States.¹²¹

It is submitted that for a soft-law mechanism to achieve an optimal degree of supervisory convergence and conformity by national financial supervisors, it must take the form of a bottom-up approach rather than the current command and control method coming from the top. One may venture to propose that a mechanism for reflexive governance of financial supervision combined with a mechanism that seeks to strengthen the mutual trust between national financial supervisors may prove to be the best possible tool for this purpose.

5.3 Reflexive Governance of Financial Supervision: Addressing the Remaining Barriers to Cross-Border Activity of UCITS

Reflexive governance is a process that promotes learning from diversity. It is characterised by flexibility, participation, power-sharing, de-centralisation, deliberation, experimentation, identification and benchmarking of best practices, knowledge-creation and revisability.¹²² The over-all focus of the process is a continuous search for better

¹¹⁹ The author was involved in a number of CESR expert groups which were responsible for the preparation of advice to the Commission at Level 2 of the Lamfalussy Process. Presently, the author is a member of various ESMA standing committees, which have replaced the CESR expert groups.

¹²⁰ Directive 2006/48/EC and Directive 2006/49/EC.

¹²¹ C Buttigieg, 'Implementing CRD for investment firms: Challenges for Malta' (2012) 20(4) Journal of Financial Regulation and Compliance 424.

¹²² O DeSchutter and J Lenoble (eds), 'Reflexive Governance: Redefining the public interest in a

approaches to address the governance problem. The constructive and valuable feature of a process of reflexivity in governance, is that the outcome of the learning-process bends back on the participants that have instigated and participated in the said process, and where exchanges between different participants in the process can result in innovation, as each participant will have to reconsider its own policies with a view of improving them, in the light of the successes and failures of others.¹²³ For reflexive governance to work, participants must be equipped to become active in the decision-making process and must be supported through *inter alia* institutional arrangements for cooperation and debate.

It is proposed that reflexive governance of financial supervision would build a process of convergence, which benefits from a certain degree of supervisory competition within a framework of cooperation, that creates the incentive to search for more effective ways of delivering financial supervision in dynamic financial markets, while simultaneously allowing a process of adaptation to cultural differences at the national level. It would be a third way between the centralisation, and therefore the full standardisation of European supervisory processes and procedures that is *inter alia* being applied in the fields of banking and credit ratings, and the fragmentation of supervision that currently exists under the UCITS Directive. Under a framework for reflexive governance of financial supervision, mechanisms for cooperation between national financial supervisors would provide the appropriate environment for experimentation and adaptation, thereby permitting an evolutionary process from the national to the European level, a process nourished by competing supervisory knowledge where the best practices are identified, codified and used as a standard for achieving convergence.

The mechanisms for cooperation between national financial supervisors provided for in the ESMA Regulation¹²⁴, such as the establishment of colleges of national financial supervisors, the delegation of supervisory powers between national financial supervisors and the conduct of peer reviews, have the potential of being operative structures for reflexive governance of financial supervision. In particular, if such mechanisms are applied as vehicles for the promotion of debate, mutual learning and the sharing of

pluralistic world' (Hart, 2010) and S Deakin, 'Reflexive Governance and European Company Law' (2009) 15(2) European Law Journal 224–245.

¹²³ DeSchutter and Lenoble (*n122*).

¹²⁴ Regulation (EU) No1095/2010, articles 21, 28, 29 and 30.

knowledge in supervisory matters. Mutual trust between financial supervisors becomes an essential ingredient for an optimal process of reflexive governance of financial supervision. A constructive and open debate on financial supervision requires mutual confidence among national financial supervisors. They must feel confident that the processes and procedures for national supervision would be applied as tools for achieving the objectives of financial regulation and would not serve the interests of their political masters or the national industry, thereby becoming an instrument of national policies and agendas which may be in conflict with the primary objectives.

In the context of the completion of the internal market for UCITS, reflexive governance of financial supervision based on these mechanisms may be applied to encourage the operation of an on-going learning process for the convergence of supervisory practices. This is required in order to overcome the weaknesses and limitations of a regulatory framework based on *quasi*-maximum harmonisation. Hence, reflexive governance which is generally presented as an alternative to the Community method, becomes a mechanism which complements the traditional mechanisms of harmonisation of hard-law, rather than acting as an alternative to them.

This section analyses and proposes a mechanism of reflexive governance of financial supervision as the solution to the remaining barriers to cross-border activity of UCITS. Reflexive governance of financial supervision is also compared with the centralised option for European supervision, which is presently the preferred policy option at EU level. The analysis demonstrates that the nature of UCITS as a retail investment product makes a process of reflexive governance the superior option towards resolving the remaining barriers to cross-border activity of UCITS.

5.3.1 National Marketing Rules

A variety of solutions may be considered to address the inefficiencies that emerge from the application of national marketing rules. The first option would be that of transforming national marketing rules into European marketing rules, which would create a standardised approach applicable in all Member States. Therefore, establishing a European single rulebook for marketing at EU level in the form of a binding Regulation. This is a solution where no degree of mutual recognition would be required

as only one set of rules would apply across the EU. This hard-law approach would guarantee legal certainty and also improve the efficient implementation of the 2009 UCITS IV Directive.¹²⁵

Nonetheless, a solution based on maximum harmonisation with regard to marketing rules would not respect the principle of subsidiarity. One of the objectives of national marketing rules is that of catering for local cultural differences, given the nature of UCITS as a financial product targeted to retail investors. These types of differences need to be appropriately addressed at the national level. For this reason, regulation of national marketing rules would appear to be an area where it would be more suitable to address the barriers to cross-border business through a soft-law mechanism based on cooperation between financial supervisors within the framework provided by ESMA.

A process of reflexive governance of financial supervision could be initiated by national financial supervisors coordinated by ESMA for the purpose of analysing the current state of implementation and the difficulties that arise from national marketing rules. Thereby, a learning process in this field would be triggered, the outcome of which could be the identification of best practices that could eventually be crystallised in Level 3 Guidance for convergence. The guidance would achieve a certain degree of consistency with regards to each category of information that may be included in national marketing rules, while at the same time allowing a certain degree of flexibility to cater for local cultural differences.

To strengthen mutual trust in this field, the national financial supervisors could agree on a peer-review mechanism of the national marketing rules coordinated by ESMA, whereby the rules of each Member State would be subject to debate and scrutiny between ESMA and national financial supervisors. After discussion and further consideration on how the specific rules address the specificities of the culture of each particular Member State, a process of codification could be applied, which would permit the updating of the Level 3 Guidance to indicate where differences exist between the Member States, the rationale for these differences and the additional best practices identified as part of the review.

¹²⁵ THEAM (*n11*).

The publication of the updated Level 3 Guidance would create an incentive at national level to move towards the best practices identified as part of the process and would also grant the industry the possibility of a better and easier understanding of the national marketing rules which are applicable across the EU. To further facilitate access to the national marketing rules of each Member State, it would appear appropriate for ESMA to have a section of its web-site dedicated to national marketing rules with links to the relevant section of the financial supervisor of each Member State's web-site, which contains these rules. This mechanism for transparency is already applied by ESMA with regard to national databases on regulated information required in terms of the TD.¹²⁶ A specific section of ESMA's web-site already provides a link to all the relevant databases.¹²⁷ The application of such a transparency mechanism would guarantee easy access to the rules and ensure compliance with the requirements of the Directive.

5.3.2 Dealing with the fragmented regulatory and supervisory framework for UCITS

Different solutions may be elaborated to address the fragmentation of the regulatory and supervisory framework for UCITS and the impact this may have on the operation of the cross-border consolidation mechanisms established in the 2009 UCITS IV Directive. A revision of the Directive may be proposed with regard to the requirements on the authorisation, constitution and functioning of UCITS with a view to achieving a higher degree of harmonisation, thereby reducing the differences between the Member States. This is an area where a hard-law approach based on *quasi*-maximum harmonisation of regulation would be the optimal solution. It would allow the necessary flexibility to secure the respect of the different national legal traditions with regard to the constitution of the UCITS, which may be formed as companies, trusts or partnerships, depending on the Member States where they are established.

With regard to differences in approaches to supervision two options would appear to be available: a centralised approach through European supervision or a mutual recognition approach based on a combination of supervisory convergence mechanisms. Under the

¹²⁶ Directive 2004/109/EC.

¹²⁷ The link to the databases <<http://www.esma.europa.eu/page/oams>> accessed 17.04.13.

centralised approach the legislator would grant powers to ESMA to monitor the authorisation and on going supervision of the UCITS. This would do away with all the supervisory differences between the Member States.

As examined in chapter 4, while there are no predetermined hard and fast rules as to the features of a financial sector that would make centralised supervision a suitable solution, in the EU a case in favour of more centralisation can be justified on account of scale and cross-border externalities arguments. Chapter 4 proposes a governance model for European supervision of securities regulation whereby large cross-border operators would be supervised by ESMA, while other operators would continue being supervised at national level. The point is made that the proposed model for supervision would need to take into account the characteristics of the market where the financial entity is undertaking its activity, including the degree of homogeneity and integration within such market, and the extent to which the protection of investors requires proximity of supervision.

Under the proposed governance model for the supervision of securities business, the centralised approach does not seem to be an appropriate solution in the context of UCITS, because of: **[i]** the different legal traditions in Member States, regarding the constitution of UCITS; and **[ii]** the need for proximity of financial supervision given that UCITS is a retail financial product, where customary behaviours are better understood and therefore better supervised by national financial supervisors. Moreover, strict adherence to the subsidiarity principle demands that a centralised solution should only be applied when the common good cannot be effectively pursued at a lower level.

Currently there is no degree of convergence in the supervision of UCITS. The area is therefore a fertile ground for experimentation and learning, and therefore an area where a process of reflexivity could be valuable. One may propose a soft-law approach based on supervisory cooperation, coordinated by ESMA, which would assess the different approaches to financial supervision at national level. Further to a mapping exercise of the different processes and procedures for supervision which apply at national level and the identification and codification of best practices in a European handbook for supervision, national financial supervisors could come to an agreement to apply the said handbook thus achieving similar, although not completely harmonised, approaches to

the supervision of UCITS. The overall European process to the supervision of UCITS would continue to benefit from a certain degree of national diversity to cater for the cultural differences at national level. It would also benefit from supervisory competition between national financial supervisors, as the proposed mechanism would permit the continued development of national financial supervisory practices that could eventually be a source for improvement of the European supervisory handbook.

Supervisory competition that emerges from reflexive governance is noticeably different from supervisory competition that results in a race to the bottom whereby Member States that are developing their financial markets pursue lax supervision in order to attract new business.¹²⁸ Reflexive governance of financial supervision would seek to direct the process of evolutionary adaptation of supervisory procedures at European level. As an integral part of this process, financial supervisors would be encouraged to compete in the establishment of principles and practices which would be recognised as optimal by other financial supervisors and would *de facto* be endorsed as precedents. It would allow the preservation of the autonomy and diversity of national financial supervision, while encouraging a process of cooperation and convergence. Hence, reflexive governance of financial supervision would equate to a race to the top instead of a race to the bottom, which should allow the development of supervisory practices that can keep up with developments in financial markets and therefore would be less conducive to failure.

To address the inefficiencies of the Level 3 mechanism in relation to uneven or non-application by national financial supervisors, the implementation of the European handbook for the supervision of UCITS would have to be closely monitored through peer reviews coordinated by ESMA, which has the power to request financial supervisors to change divergent practices where these are not justified or where these do not sustain robust supervision.¹²⁹ However, under a system of reflexive governance of financial supervision, peer reviews would not only be a mechanism for monitoring but would also become a tool for mutual learning and knowledge creation. Any identified differences would be considered and new best practices would be identified and

¹²⁸ I Chiu, 'Regulatory Convergence in EU Securities Regulation' (Kluwer Law 2008) 9; and C Tietje and M Lehmann, 'The Role and Prospects of International Law in Financial Regulation and Supervision' (2010) 13(3) *Journal of International Economic Law* 663.

¹²⁹ Regulation (EU) No 1095/2010, articles 29 and 30.

eventually incorporated in the European handbook. Thereby, the monitoring process would not only serve as an instrument for enforcement but also as a device for establishing another dimension to the overall debate on the governance of financial supervision and the best way to resolve the supervision dilemma.

5.3.3 Addressing the Supervisory Concerns arising from the Management Company Passport and the Internal Market for Depositaries

A number of different mechanisms may be applied by policy-makers to address the fragmentation in the financial supervision of management companies and allow the unobstructed operation of the passport. One of the options could be that of applying a centralised approach operated by ESMA. In terms of this approach, ESMA would be granted authorisation and supervisory powers over management companies in the EU. Management companies would be subject to one authorisation process and on-going supervision at the level of ESMA. This would give management companies immediate access to the internal market without requiring any form of passporting and split supervision.

Such an approach could create difficulties given the geographical distribution of management companies in Member States and the need for proximity of supervision of areas of regulation such as the conduct of business rules applicable to these companies. In this context, effective supervision depends on an understanding of the local customs in doing business. These difficulties could be resolved through agreements between ESMA and national financial supervisors. The latter would act as supervisory agents for ESMA. This, however, could result once again in a fragmented approach to supervision in view of the different supervisory practices which apply at national level.

For the centralised solution to operate, it would still require close intervention at national level and would have to be combined with a soft-law approach in the form of a European handbook for the supervision of management companies. On the basis that financial supervisors at national level are best placed to examine how the management company operates on a daily basis, it is doubtful whether the centralised approach for the supervision of management companies can be considered as appropriate and proportional. Moreover, given the need for proximity of supervision, under the

governance model for financial supervision proposed in chapter 4, it is unlikely that the centralised approach would satisfy the principle of subsidiarity.

Respecting the high-level EU principles of proportionality and subsidiarity would suggest that a soft-law option devoid of the centralised approach would be the optimum solution for the financial supervision of management companies. The solution again lies in strengthening the link between financial supervisors through a process of reflexive governance of financial supervision. The outcome of such a process would be the establishment and creation of a European handbook for supervision of management companies which would codify the best practices in this field and would also propose options for the operation of a mechanism for the delegation of supervisory tasks between financial supervisors in this area.

Hence, an approach which would be based on mutual understanding, learning and cooperation, which strengthens mutual trust between national financial supervisors and which recognises the importance of allowing a certain degree of diversity of supervisory practices within a framework for convergence remains an important part of the overall solution given the national cultural differences in this field.

There is no degree of consistency in the national procedures for the supervision of management companies. Establishing one particular way of carrying out supervision of management companies to overcome fragmentation is a complex task given national cultural differences that exist in the retail market and the long established supervisory traditions in this field. The benefit of a reflexive approach over a centralised European approach, which imposes a method of supervision from the top, is that it would encourage national financial supervisors to consider and reflect upon the goals of financial supervision of management companies and the difficulties that arise from fragmented supervision and how supervisory practices which are applied at national level might be rethought to move away from fragmentation. By so doing, it would encourage national financial supervisors to make proposals for a convergent approach based on national best practices, to discuss those proposals with other national financial supervisors, to reconsider whether these are adequate and how far these need to be reconstructed in the light of that deliberation.

Through a process of mutual interdependence, learning and deliberation coordinated within the structures provided by ESMA, national financial supervisors would become the *owners* of the solution for supervisory cooperation and convergence. This ownership would encourage compliance and thereby succeed in bringing about the transformation of national supervisory practices and the implementation of the degree of homogeneity that overcomes fragmentation, while at the same time allowing for a certain degree of national practices to co-exist with convergence, in order to cater for cultural differences. Hence, the benefit of a reflexive process to financial supervision over the centralised approach for European supervision, is that through this process national financial supervisors would be encouraged to see their participation in a process for convergence not just as an external commitment but as a chance to learn from, and evaluate, the practices of other national financial supervisors.

Such a soft-law approach would add certainty to the supervisory process within the EU. At the same time it would allow the approach to supervision to develop through a learning process achieved from healthy supervisory competition between Member States aimed at finding better ways to address the supervisory challenge. Healthy supervisory competition allows supervisors to learn from each other, which in turn benefits the EU supervisory system as a whole.

It is submitted that in the context of cross-border UCITS structures, a framework for cooperation in the form of delegation of supervisory tasks could be of significance for the reduction of supervisory fragmentation, particularly in the case of split supervision of management companies. This would be specifically relevant in relation to the conduct of on-site compliance monitoring of management companies, covering specific areas of regulation such as conduct of business rules where the regulatory framework of the host-Member State applies to a passporting manager. This means that supervisory tasks relating to the on-site inspection are carried out by the delegated financial supervisor. Its findings are reported back, discussed and analysed together with the delegating financial supervisor for further action.¹³⁰ This mechanism, together with the application of a European supervisory handbook, should guarantee a certain degree of

¹³⁰ Regulation (EU) No 1095/2010, recital 24 and article 28.

homogeneity in the practices of financial supervision thereby reducing the impact of fragmentation.

A system for reflexive governance of financial supervision based on tools for supervisory cooperation, resulting in convergence, would also seem to be the optimum solution to resolve the depositary passport conundrum.

On the assumption that the ten global custodians are the players that would exercise a passport to provide depositary services across the EU and which would compete on a cross-border level, in line with the governance model for financial supervision proposed in chapter 4, one could argue that centralised supervision should be applied, as shared supervision may be highly inefficient and may not be adequate to ensure stability. However, given the serious retail investor protection concerns that could arise from the losses suffered in case of failure of a depositary, national financial supervisors would want to retain supervisory control over depositary business.¹³¹ It is most likely that the supervisors of the UCITS and the management companies serviced by the depositary, would want to participate in the supervision of the depositary together with the depositary's home financial supervisor.

To resolve the possible supervisory inefficiencies that could result from fragmented supervision involving several supervisors, while addressing the existing desire for national supervision, it is submitted that a measure that should be considered is the setting up of colleges of supervisors coordinated by ESMA.¹³² This solution would leave supervision at the level of the home Member State, while recognising the need for other Member States to take a role in the supervisory process. In this regard, the college of supervisors would create a forum for discussion, mutual cooperation and learning which would in turn enhance a process of reflexivity in financial supervision that would contribute to the overall process of convergence.

Nevertheless, for the proposed framework for reflexive governance of financial supervision to operate effectively, a high degree of mutual trust is required among

¹³¹ This position taken by the regulators interviewed for the purpose of the thesis. For further information, see the methodology section in chapter 1 and annexes 1 and 2.

¹³² Regulation (EU) No1095/2010, recital 36 and article 21.

national financial supervisors. The key question remains: Why would a national financial supervisor trust another's supervisory practices, unless it is comfortable with its standards and governance for supervision?

Reflexive governance of financial supervision cannot work successfully unless a European mechanism for the strengthening of mutual trust between financial supervisors is devised and implemented. The pursuing of national agendas is the main source of mutual distrust between national financial supervisors. The application of a European framework, which guarantees the autonomy and proper accountability of national financial supervisors is therefore important if the existing concerns that national financial supervisors may be subject to political or industry capture¹³³ are to be addressed in practice.

5.4 Strengthening the Governance of Financial Supervision

The institutional framework applied for the purpose of financial supervision and the governance arrangements that contribute to a timely and fair decision-making process which aims at achieving financial stability and investor protection, are determinants of effective financial supervision.

The institutional framework for financial supervision varies between Member States, in particular, the extent to which these integrate the micro-prudential supervision of financial sub-sectors. Empirical research on the governance of financial supervision concluded that the quality of the independence, accountability, transparency and integrity structures of a financial supervisor have a bearing on the effectiveness of financial supervision and the degree of financial soundness.¹³⁴ It has also determined that an arm's length relationship between the financial supervisor and the government

¹³³ M Quintyn and M Taylor, 'Robust Regulators and Their Political Masters: Independence and Accountability in Theory' in D Masciandaro and M Quintyn, *Designing Financial Supervision Institutions* (Edward Elgar 2007) 34. This concern was also raised, with regard to the Spanish banking crisis, in the IMF's review of Spain's compliance with the Basel Principles for Effective Supervision in June 2012 Report No12/142 13<<http://goo.gl/SaJPVx>>accessed 13.05.13.

¹³⁴ See amongst others the empirical research carried out by: U Das, M Quintyn, and K Chenard, 'Does Regulatory Governance Matter for Financial System Stability? An Empirical Analysis' IMF Working Paper 04/89 (2004)<<http://goo.gl/6XxvF2>>accessed 04.01.13; M Arnone, and A Gambini, 'Architectures of Financial Supervisory Authorities and Banking Supervision' in D Masciandaro and M Quintyn, *Designing Financial Supervision Institutions* (Edward Elgar 2007) 262-309.

improves the quality of financial supervision and has a role in removing obstacles to the development of the financial sector.¹³⁵

While the institutional model for financial supervision is likely to have an effect on the quality and effectiveness of supervision, in itself it does not guarantee it.¹³⁶ Noticeably, effective financial supervision is primarily a function of the internal governance arrangements for this purpose. Unless a financial supervisor operates within a framework built on high-level standards of internal governance, such as independent decision-making, autonomy (operational independence), accountability, fairness and transparency and has proper powers and competent human resources to fulfil its duties, it is doubtful whether effective supervision may be achieved in practice.¹³⁷

Sound governance of financial supervision is therefore critical for mutual recognition, which is based on mutual confidence that financial supervisors will act in a similar prudent manner. The capacity to act on an equal footing is an important pre-condition for trust between supervisors. A true level playing field depends crucially on the actual effective application of such powers and the manner in which they are applied. Concerns about the supervisory competition between Member States to attract financial institutions to their jurisdiction¹³⁸ or a protectionist approach to guard their industry from cross-border competition where the financial system of the particular Member State is uncompetitive¹³⁹ have led policy-makers to call for a more robust framework which regulates governance of European financial supervision.

Within the context of the internal market, aims of a financial supervisor that go beyond and which may be in conflict with the objective of financial regulation, could have a negative impact on the operation and integrity of the internal market, since the possible negative effects of national policy could quickly propagate to other Member States.

¹³⁵ T Beck, A Demirguc-Kunt, and L Ross, 'Bank Supervision and Corporate Finance' NBER Paper 9620 (2003) <<http://go.gl/4R2s2W>> accessed 04.01.13.

¹³⁶ C Buttigieg, 'The Institutional Models for Financial Supervision: An Analysis' (2013) *The Accountant*.

¹³⁷ Buttigieg (n136).

¹³⁸ M Lamandini, 'Towards a New Architecture for European Banking Supervision' (2009) 6(1) *European Company Law* 6-13.

¹³⁹ D Gross, 'Comments on the article by A Enria and J Vesala, 'Externalities in supervision: the European case' in J Kremers, D Schoenmaker, P Wierds (eds), *Financial Supervision in Europe* (Edward Elgar 2003) 90-93.

Financial supervision that is distorted by national or personal agendas may be the cause of mutual distrust between financial supervisors. Mutual confidence largely depends on the knowledge that a financial supervisor has the necessary characteristics, including competence, focus and resources, that make it honest and competent to undertake its responsibilities.¹⁴⁰

The DeLarosiére Report emphasised:

The ESFS must be independent from possible political and industry influences, at both EU and national level. This means that supervisors should have clear mandates and tasks as well as sufficient resources and powers. In order to strengthen legitimacy and as a counterpart for independence, proper accountability to the political authorities at the EU and national levels should be ensured. In short, supervisory work must be independent from the political authorities, but fully accountable to them.¹⁴¹

Notwithstanding the calls by policy-makers for mechanisms which guarantee the autonomy and the accountability of financial supervisors, at present, the harmonisation of the governance arrangements for financial supervision, is limited to the powers to supervise, investigate, sanction and exchange information. This harmonisation process was triggered *inter alia* by the DeLarosiére Report¹⁴², although concerns on inconsistencies in this area had long been raised by policy-makers and financial supervisors.¹⁴³

In the field of UCITS changes to the Directive to harmonise the powers to supervise, investigate, sanction and exchange information form part of the 2012 UCITS V Proposal. It is submitted that these changes will be futile unless a framework is devised to guarantee the autonomy and accountability of financial supervisors. These are critical

¹⁴⁰ CESR, 'Preliminary Progress Report: Which Supervisory tools for the EU Securities Markets? An Analytical Paper by CESR', (Ref:04-333f), October 2004<<http://goo.gl/bvWyNY>>accessed 16.03.14.

¹⁴¹ 'High-Level Group on Financial Supervision in the EU – Report' (Brussels, 25.02.09) 15–19<<http://goo.gl/CroZY>>accessed 15.03.14.

¹⁴² DeLarosiére (*n141*) 41.

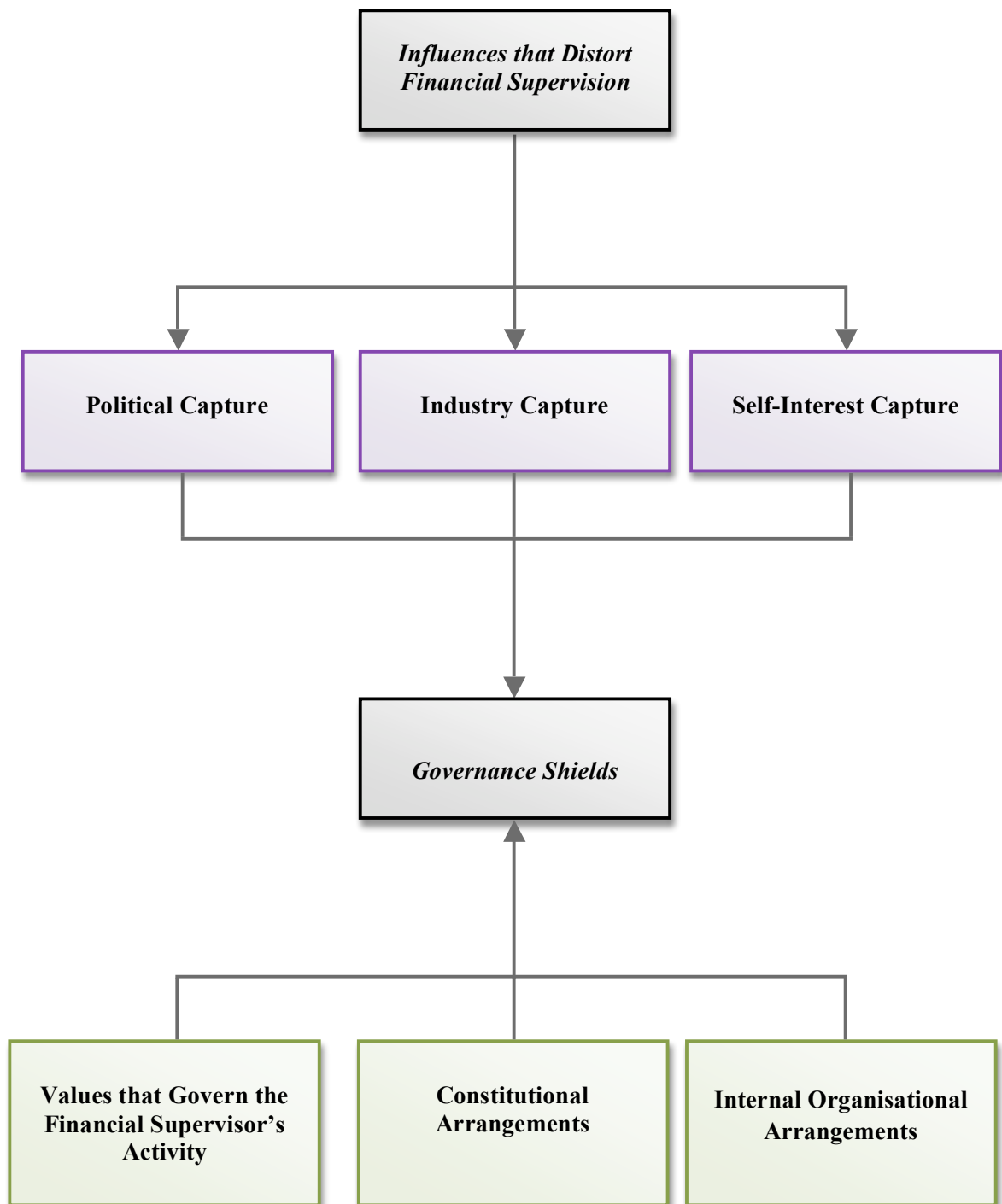
¹⁴³ EBF, 'State of Integration of Europe's Financial Markets – Comments of the EBF on the Reports of the Banking and Securities Groups' September 2004<www.ebf-fbe.eu>accessed 12.10.12; and CESR, 'CESR assesses the extent of equivalence of supervisory powers across Europe under the Market Abuse and Prospectus Directive' (Press Release,07-420) 21.07.07<<http://goo.gl/ozJfKm>>accessed 16.03.14.

for the creation of a common supervisory culture and to enhance cooperation between financial supervisors. A regulatory framework for this purpose would establish an important evolutionary enhancement to the overall governance of financial supervision in Member States, thereby strengthening mutual trust between financial supervisors.

5.4.1 Governance Arrangements for the Independence, Autonomy and Accountability of Financial Supervisors

The degree of independence and autonomy of a financial supervisor from government and the industry depends on the extent to which its internal processes are insulated from influences that distort its activity from achieving the objectives of regulation. Such negative influences may come in the form of pressures to serve political motives ('political capture') or the financial interests of private individuals or organisations ('industry capture'). They may also come in the form of personal career objectives ('self-interest capture').

To mitigate the influences that may arise from regulatory capture, a policy decision to establish an autonomous financial supervisor inevitably requires the application of a set of governance shields, more specifically: [i] the values that are to govern the supervisor's overall activity; [ii] the constitutional arrangements for its establishment; and [iii] its internal organisational arrangements. A proper combination of these elements would generally have a bearing on the extent to which the financial supervisor would be in a position to shield itself from the influences that could distort the focus of its supervisory activity.

Diagram 5.2 – Influences that Distort Supervision and the Governance Shields.

The overarching values that govern the activity of a financial supervisor have an impact on the degree to which it will be in a position to realise the objectives of financial regulation. A financial supervisor whose primary aim is that of accomplishing the common good is generally guided by the normative values of fairness, equity, integrity and responsibility. On the other hand, where the executives who steer the activity of a

financial supervisor are guided principally by self-interest and career concerns, the supervisory environment could end up being characterised different forms of regulatory capture and conflicts of interests that generate suspect regulatory choices.¹⁴⁴

Independence, that is the capability of exercising discretion in decision-making, may be distorted by regulatory capture where a financial supervisor feels vulnerable to political powers that be or those of the future. Vulnerability that results in industry capture exists where those responsible for financial supervision become too familiar with the financial industry or have career plans which go beyond working with the financial supervisor. Both political and industry related vulnerabilities make the officials responsible for steering the financial supervisor susceptible to external influence in decision making and undermine the *de facto* independence of the institution. Independence should not be interpreted narrowly and also extends to the supervisor's autonomy, i.e. whether it has the resources to be in position to operate and function without government support or approval. Indeed, the point has been made that the principle:

... that a regulator be “operationally independent from political interference” is not to be interpreted ... as applying only to a minister seeking to interfere in an insider dealing case. When a government can demand that a regulator takes on additional work as specified by the Government such that resources have to be diverted from day to day supervision and even from enforcement the operational independence of the regulator is called into question.¹⁴⁵

A financial supervisor should therefore have the governance arrangements in place to resist undertaking tasks that are unrelated to its core activity. Financial supervisors should not be distracted by auxiliary work, where it can find itself subjected to influence or criticism by third parties.

It follows that unless there is: **[i]** a clear direction regarding the values that should be at

¹⁴⁴ L Enriques and G Hertig, ‘Improving the governance of financial supervisors’ (2011) 12(3) European Business Organisation Law Review 363; R Dijkstra ‘Accountability of financial supervisory agencies: an incentive approach’ (2010) 11(2) Journal of Banking Regulation; and G Stigler, ‘The Theory of Economic Regulation’, (1971) 2(1) The Bell Journal of Economics and Management Science 3-21.

¹⁴⁵ IMF, ‘Sweden FSAP Update - Assessment of Observance on IOSCO Principles and Objectives of Securities Regulation’ September 2011 <<http://goo.gl/SaJPVx>> accessed 04.01.14.

the heart of the financial supervisors' work; [ii] procedural guarantees in terms of both the manner and the eagerness of decision-making; and [iii] proper accountability structures in place (including the possibility of judicial review as a safeguard for objectivity), the independence and discretion granted to financial supervisors could be easily abused.

Therefore, it is logical that at law the independence, objectives and overarching values set for a financial supervisor, its decision making procedures and the accountability mechanisms, should be clearly stipulated in the constitutional document that establishes the agency, and should be the blueprint for its over-all governance. Moreover, the internal governance arrangements and the procedures employed for steering the financial supervisor should guarantee its *de facto* independence. Autonomous institutions without clear objectives and functions, sound organisational structure and governance are fragile and condemned to malfunction, as they will not be in a position to achieve the objectives they have been created to attain.¹⁴⁶

Hence, if the financial supervisor is to serve as a source of commitment in decision making for the attainment of the objectives of financial regulation, the constitutional document should clearly provide for its objectives, role, competence, duties and discretionary powers and define its various organs together with their respective roles and responsibilities.

The constitutional document should also empower the financial supervisor to raise its own income, set its own salary packages and enter into contracts without requiring government approval. The point has been made that monetary incentives are indeed crucial for a financial supervisor to be in a position to attract and retain talented candidates, to reward high performance and foster dedication, all of which are important to strengthen the effectiveness of supervision.¹⁴⁷ Indeed, the quality and robustness of financial supervision may be at risk where the financial supervisor's functional independence is constrained. This is particularly relevant where the funding method for the financial supervisor does not provide sufficient financial resources to allow the

¹⁴⁶ A Farazmand, 'Sound Governance in the Age of Globalization: A Conceptual Framework' in '*Sound Governance: Policy and Administrative Innovations*' (Praeger Publishers 2004) 1-24.

¹⁴⁷ R Lastra, 'The Independence of the European Systems of Central Banks' (1992) 33(2) Harvard International Law Journal 486.

agency to meet its regulatory and operational needs on a long-term basis. This is the position in the US as reported by the IMF in their 2010 FSAP report.¹⁴⁸ Ultimately, budgetary freedom is a fundamental component of a financial supervisor's autonomy both *vis-à-vis* government and with respect to the industry.

To strengthen further the *de facto* independence of financial supervision, the overarching values of the financial supervisor should constitute a measure for determining some of the necessary characteristics and professionalism which are required of the members who will compose the financial supervisor's governing body, the executives engaged to lead its supervisory and administrative organs and the officials who will be involved in financial supervision. Professional judgement, expert knowledge, impartiality and intellectual honesty are all essential criteria to achieve professional independence, competence and credibility. Ultimately, regulation and supervision will be more effective if the industry perceives that the financial supervisor is steered by officials who are professionally independent and who will deal with them fairly and honestly, and that decisions will be carefully considered, not arbitrarily imposed and that therefore they will be realistic, not doctrinaire. In this connection, it has been argued that:

Professional independence – which contributes to the reputation and prestige of the institution – is also safeguarded by the establishment of a list of incompatible or disqualifying activities so as to prevent conflicts of interest. For instance, while in office [financial supervisors] should be precluded from simultaneously holding private-sector jobs.¹⁴⁹

Therefore, in seeking to ensure that only the right people are engaged for the purpose of steering the financial supervisor, the constitutional document should perhaps define the criteria which determine the fundamental qualities of such persons. As a minimum, they should be characterised by integrity, competence and solvency. By reference to the EU regulation which grants the ECB the role of banking supervisor and specifically the

¹⁴⁸ IMF, 'United States: Publication of Financial Sector Assessment Program Documentation— Detailed Assessment of Implementation of the IOSCO Objectives and Principles of Securities Regulation', May 2010 <<http://goo.gl/l6llA2>> accessed 03.01.13.

¹⁴⁹ R Lastra, 'Central Bank Independence and Financial Stability' (2010) Banco De Espana Estabilizado Financiera 56.

provisions on the appointment of the supervisory board, it is reasonable to suggest that the executives of a financial supervisor should be individuals of recognised standing and experience in financial services.¹⁵⁰ On an on-going basis, these overarching values of the financial supervisor would also serve as some of the measures which may be used for assessing the correctness in the financial supervisor's performance, by reviewing whether the overarching values are reflected in the decision made by the supervisor's executives or whether their choices have been inspired by less honourable objectives.

Devising the governance structure of a financial supervisor requires the introduction of structural guarantees and institutional arrangements that seek to ensure that the financial supervisor pursues the objectives of financial regulation. These arrangements should be designed to minimize the possibility of slippage in the direction of regulatory capture. Different types of procedural controls may be applied in order to contain slippage and opportunistic behavior which may occur as a consequence of the powers and discretion granted to the financial supervisor. Of particular significance is the procedure for the selection of the officials who will steer the financial supervisor, whereby the persons to be selected should be required to demonstrate that they have the personality, experience, technical ability and leadership skills which are required to allow them to set the agenda, gain the respect of stakeholders and avoid being controlled by third parties whether political or the industry. In the end, a procedure which objectively and effectively tests the candidate's experience, knowledge and ability to achieve the objectives of regulation, strengthens even further the professional independence of the financial supervisor.¹⁵¹

It has been suggested that rules of conduct that bind a financial supervisor to a specific course of action in making supervisory decisions may be applied as a control mechanism to guarantee independence in the decision making process.¹⁵² However, such rules would significantly limit the financial supervisor's discretion, which is essential for the proper conduct of its functions. A more workable proposal, which is applied in practice, is that of requiring supervisory decisions to be made collegially by

¹⁵⁰ Regulation (EU) No1024/2013, article 26.

¹⁵¹ Lastra (*n147*) 482.

¹⁵² C Goodhart, 'Regulating the Regulator – An Economist's Perspective on Accountability and Control' in E Ferran and C Goodhart, *'Regulating Financial Services and Markets in the 21st Century'* (Hart 2001) 157.

an independent college of commissioners experienced in financial supervision, having the role of reviewing proposed supervisory decisions and requesting justifying reasons for a proposed course of action, before the final supervisory decision is made and issued.

Moreover, the risk of politically driven interventions in the day-to-day operations of the financial supervisor may be reduced if the institutional design of the financial supervisor provides for a separation of powers between those relating to policy, to be exercised by the main board of the organisation appointed by government, and the powers necessary for the conduct of day-to-day supervision, which may be allocated to a chief regulator appointed by the board and who is therefore completely independent from government.¹⁵³ The rationale for such separation of powers is that board members are generally political appointees who might not have regulatory experience, in certain instances former politicians including cabinet members, and as a consequence closer to politicians than staff members, and therefore their participation in day-to-day supervision increases the risk of political capture.

On the other hand, a chief regulator and the other members of staff are appointed by the board and should in theory be less prone to this type of capture. While this is a valid proposal, experience with the operation of this type of governance mechanism suggests that senior officials within a financial supervisor could however also be subject to political capture, especially in circumstances where the particular official harbors higher career ambitions within the agency or in other government institutions. Therefore, this tool on its own is not enough to guarantee the independence of a chief financial supervisor. It follows that to avoid such form of capture a chief regulator should ideally be of an age that excludes this form of career aspirations. Moreover, these mechanisms should be supported by other governance arrangements such as by making appointments for a tenure that is longer than that held by legislators¹⁵⁴ or by imposing term limits.

Term limits is another governance tool, which is considered effective to avoid undue dependence and to guarantee a certain degree of *de facto* independence of the appointee responsible for steering the financial supervisor. Without term limits a chief financial

¹⁵³ Enriques et al (n144) 365.

¹⁵⁴ Lastra (n147).

supervisor in office may become too influential and authoritative in relation to outsiders, so that competition for the office of a chief financial supervisor could become distorted with tenure. Moreover, in the absence of term limits, the value of remaining in office may become excessively significant, which in turn could trigger a chief financial supervisor to focus his/her energy on ensuring re-appointment and consequently divert time from supervisory work. Therefore, it becomes best practice to adopt the approach of granting appointments only for a fixed term which is non-renewable, but sufficient to safeguard independence while gathering enough expertise in the job to deliver long term objectives. This is the approach taken with regards to the position of the Chairman of the ECB's supervisory board, who is appointed for a period of five years which is non-renewable.¹⁵⁵

In the final analysis, procedural guarantees may not be effective unless the executive of a financial supervisor who has the power to make regulatory and supervisory decisions, is made accountable for any ramifications of his/her actions. Accountability is an obligation owed by one person (the accountable) to another (the accountee), whereby the accountable must explain and justify his/her actions or decisions against specified criteria and take responsibility for failure, possibly entailing where relevant the possible dismissal of the accountable.¹⁵⁶ There are different forms of accountability that may be applied. In the case of a financial supervisor, accountability is generally owed to the judiciary, whereby the courts are granted the power to review administrative actions or decisions by the financial supervisor, and to parliament, which allows monitoring of independent agencies by a democratically elected institution.¹⁵⁷

Hence, accountability arrangements serve as a monitoring mechanism, which seeks to ensure that the financial supervisor acts diligently and fairly, does not abuse its powers and is not controlled by third parties, such as the industry they supervise. Accountability also becomes a solution to the legitimacy concerns that surface from the possibility that a financial supervisor having broad responsibilities and enforcement powers could become a law unto itself. Accountability arrangements thus serve as a support for the financial supervisor's independence.

¹⁵⁵ Regulation (EU) No1024/2013, Article 26.

¹⁵⁶ R Lastra and H Shams, 'Public Accountability in the Financial Sector' in E Ferran and C Goodhart, *'Regulating Financial Services and Markets in the 21st Century'* (Hart 2001) 165-188.

¹⁵⁷ Lastra and Shams (n156).

Financial regulation and supervision decision making is likely to draw in politically sensitive trade offs, such as those between economic efficiency and social well-being or concerning investor protection and competition. Such decisions may be regarded as being shifted from democratically elected institutions to non-democratically elected bureaucratic agencies.¹⁵⁸ In a democratic system, a social order is legitimate where the policy-makers are accountable to their citizens who are given the opportunity to partake in rule-making through representation and can express their disagreement with the policy-makers by voting them out of office. This infers a certain degree of equivalence between the policy-makers and the citizens through mechanisms of representation. Supervisory independence makes the democratic mechanism that allows constituents to make a binding decision on the performance of the ruling parties an unworkable mechanism for the operation of a financial supervisor. Moreover, while the political establishment can transfer binding powers to a financial supervisor, politicians cannot transfer their legitimacy. It follows that in the eyes of the general public, the financial supervisors might face legitimacy drawbacks.

In order to achieve social legitimacy and market credibility, the discretionary independence of a financial supervisor needs to be supported by positive performance in the fulfilment of its duties and mechanisms for accountability,¹⁵⁹ whereby the greater the discretion granted to the financial supervisor, the greater the need for adequate accountability.¹⁶⁰ Ultimately, *accountable independence*¹⁶¹ provides society with a certain degree of assurance that financial supervision is being carried out for the right reasons and is not being influenced, undermined or abused by private interests.

The concept of accountability entails that the actors being held accountable have obligations to act in ways that are consistent with accepted standards of behaviour and

¹⁵⁸ L Bini Smaghi, 'Independence and Accountability in Supervision: General Principles and European Setting' in 'D Masciandaro and M Quintyn, *Designing Financial Supervision Institutions*' (Edward Elgar 2007) 41-62.

¹⁵⁹ Lastra (n147); G Majone, 'The Rise of the Regulatory State in Europe' (1994) *West European Politics* 93; A Page, 'Regulating the Regulator – A Lawyer's Perspective on Accountability and Control' in E Ferran and C Goodhart, *Regulating Financial Services and Markets in the 21st Century*' (Hart 2001) 127-149.

¹⁶⁰ Lastra and Shams (n156).

¹⁶¹ This usage is borrowed from Lastra (n147) 481.

that they will be sanctioned for failures to do so.¹⁶² In this regard, judicial review of the financial supervisor's decisions is crucial to control the unreasonable exercise of discretionary powers.¹⁶³ On the other hand, with regard to accountability to government, in order not to jeopardise the independence of the financial supervisor, accountability should be established through a combination of control instruments in such a way that no one really controls the financial supervisor, yet the agency is under control.¹⁶⁴ In this regard, transparency, which is an essential feature of good governance, becomes a complement to accountability.¹⁶⁵ It has been argued that:

The provision of information in the context of accountability, whether in an ex ante investigation or an ex post requirement of disclosure, facilitates transparency. On the other hand, a transparent economic and political environment enhances the effectiveness of accountability.¹⁶⁶

Nonetheless, the publication of information on financial supervision has to be selective as the actual benefit of full transparency on supervisory matters is not entirely clear.¹⁶⁷ This is particularly true given the potential uncertainty and instability that could be generated by transparency of information on serious supervisory concerns such as the potential failure of a financial institution.¹⁶⁸ Moreover, confidentiality constraints exist with regard to supervisory matters. Indeed, it has been argued that a tension exists between the duty to be accountable by disclosing information and the duty to retain supervisory information confidential.¹⁶⁹ In this regard, it is reasonable to suggest that this tension may be loosened through possible agreements between the accountable and the accountee on restricted access and confidentiality by the accountee, such as those reached between the European Parliament and the ECB within the context of the Single

¹⁶² R Grant and R Keohane, 'Accountability and abuse of power in world politics' (2005) 99(1) *American Political Science Review* 29.

¹⁶³ Lastra and Shams (n156).

¹⁶⁴ T Moe, 'Interests, Institutions, and Positive Theory: the Politics of NLBR' (1987) 2 *Studies in American Political Development* 236–299.

¹⁶⁵ R Lastra, 'Accountability and Governance: Banking Union Proposals' DSF Policy Paper Series No30, November 2012 <<http://goo.gl/apX2Ve>> accessed 02.01.14.

¹⁶⁶ Lastra and Shams (n156).

¹⁶⁷ F Amtenbrink and R Lastra, 'Securing Democratic Accountability of Financial Regulatory Agencies – A Theoretical Framework' in R Mulder (ed), *Mitigating Risk in the Context of safety and security. How relevant is a Rationale Approach?* (Rotterdam: Erasmus School of Law & Research School of Safety and Security (OMV) 2008) 115–132.

¹⁶⁸ Lastra (n165) 9.

¹⁶⁹ Lastra (n165) 9.

Supervisory Mechanism ('SSM').¹⁷⁰

In terms of accountability to government, on the one hand the executives of a financial supervisor must be independent of political influence, while on the other hand they also need to be held accountable for their activities. Parliamentary accountability, which is a democratically elected institution, would appear to be the best choice for this purpose as clearly ministerial intervention should be avoided, as this could easily result in interference by the executive and political capture. Nonetheless, coordination with the executive is important to ensure consistent overall policy making.¹⁷¹ Moreover, while parliament should be in position to review, assess and comment on the activity of a financial supervisor it should not be granted powers to exercise immediate authority on the financial supervisor by interfering directly in its supervisory activity.¹⁷² Therefore, a delicate balance must be struck in the construction of this accountability mechanism. One may argue that the optimal solution would be to assign a parliamentary committee for this purpose that is provided with the required information to facilitate opinion-formation on the performance of the financial supervisor and which takes a results oriented approach in assessing its functioning.¹⁷³

Such parliamentary committee would be responsible for assessing the performance of the activity of the financial supervisor and make a judgement call on whether it has achieved the objectives for which it was established, and more particularly the extent to which it has contributed towards attaining the objectives of financial regulation. The composition of such parliamentary committee should include representatives from all the spheres of the political divide, who should preferably have some form of understanding about nature of financial supervision. This would guarantee that no special allegiance with one particular party is formed and that no bias is allowed with regard to the assessment of the performance of the financial supervisor.

¹⁷⁰ The European Parliament and the European Central Bank, 'Inter-Institutional Agreement (IIA) between European Parliament and ECB on the cooperation on procedures related to the Single Supervisory Mechanism (SSM)' 2013 <<http://goo.gl/e5X8Tq>> accessed 04.01.14.

¹⁷¹ Amtenbrink and Lastra (*n167*).

¹⁷² E Hupkes, M Quintyn, and M Taylor, 'The Accountability of Financial Sector Supervisors – Principles and Practice' (2005) 16(6) *European Business Law Review* 1575–1620.

¹⁷³ Amtenbrink and Lastra (*n167*).

Assessing the performance of the activity of the financial supervisor may be a complex task, as thus far no real objective criteria, either quantitative or qualitative, have been established on what is appropriate in terms of *ex-post* assessment of financial supervision. In this regard, input or process monitoring is considered to be the optimal solution to assess a financial supervisor's performance.¹⁷⁴ One may further suggest that the instability within the financial system and investor losses (amongst others) may also be applied as possible measures of a financial supervisor's success, although accountability cannot simply rely on whether or not crises are taking place.¹⁷⁵ On the other hand, the identification, prevention and risk management of future potential financial debacles may be applied as a standard for the assessment of the performance of financial supervision, which may be achieved through an examination of the processes applied by a financial supervisor in determining where to focus its supervisory activity and the manner in which this contributes to a stable financial system.

5.4.2 An EU Framework for the Strengthening of Mutual Trust between Financial Supervisors

Unless a financial supervisor operates within a framework built on high-level standards of sound internal governance, such as independent decision making, accountability, integrity and fairness of judgement, transparency and adequacy of powers and resources, it is doubtful whether effective financial supervision may be achieved. In practice while there has been an upward trend in the implementation of sound internal governance arrangements for financial supervision across jurisdictions, the process has not been uniform and in certain cases reversals have been noted.¹⁷⁶

Several reasons explain the apparent unsystematic application of high-level standards of sound internal governance for financial supervision. With regard to independence, it has been determined that policy-makers are still rather reluctant to grant full independence

¹⁷⁴ L Garciano and R Lastra, 'Towards a new Architecture for Financial Stability: Seven Principles' (2010) 13(3) *Journal of International Economic Law* 597–621.

¹⁷⁵ Garciano and Lastra (*n174*).

¹⁷⁶ M Quintyn, S Ramirez and M Taylor, 'The Fear of Freedom: Politicians and the Independence and Accountability of Financial Supervisors in Practice' in D Masciandaro and M Quintyn, *Designing Financial Supervision Institutions* (Edward Elgar 2007) 63–116.

to financial supervisors as *inter alia* politicians still want a certain degree of control over those activities that can generate political benefits such as the licensing and de-licensing of financial institutions.¹⁷⁷

Empirical research has shown that in certain instances the move toward a higher degree of independence has been held back by *inter alia* the introduction or, in certain cases, the continuation by some governments of control-arrangements, such as appointing a minister as head of the board, or putting a clause in the law allowing the minister to intervene in the financial supervisor's operation, where necessary.¹⁷⁸ These type of arrangements are often justified as accountability mechanisms. However, one may argue that their ultimate objective is that of controlling the financial supervisor rather than sustaining its independence. Evidence on this point may be derived from the IMF FSAP reports, which indicate that in certain instances financial supervisors were constrained from action or followed government agenda of the day, and therefore did not intervene to enquire about questionable financial practices that supported short-term national financial prosperity.¹⁷⁹

A case in point is Spain. An IMF assessment of Spain's compliance with international standards and codes on banking and securities regulation brought to light the significant powers exercised by the Ministry of Economy over the regulatory and supervisory process.¹⁸⁰ The Ministry has a representative on the board of the Bank of Spain and the Spanish CNMV with voting powers. The review determined that the power to issue financial services licences in Spain rests with the Ministry and not with the Bank of Spain and the Spanish CNMV. These two financial supervisors do not have the power to revoke authorisations or impose sanctions for serious breaches of the regulatory framework. These functions are remitted to the Ministry.

Another interesting example is the IMF's assessment of the Luxembourg CSSF. The IMF concluded that the legal framework which establishes the Luxembourg regulator

¹⁷⁷ Quintyn *et al* (n176).

¹⁷⁸ Quintyn *et al* (n176).

¹⁷⁹ FSB, 'Report on the Peer Review of Spain' (Basel, January 2011) 4<<http://goo.gl/2MV8Xd>>accessed 10.12.12.

¹⁸⁰ IMF, 'Spain: Basel Principles for Effective Supervision and IOSCO Objectives and Principles of Securities Regulation – Detailed Assessment Implementation - June 2012 Reports No12/142 / 12/143<www.imf.org>accessed 16.05.13.

does not sufficiently guarantee the full operational independence of the CSSF: the CSSF is placed under the direct authority of the Minister; its missions include the “orderly expansion” of Luxembourg’s financial center; its general policy and budget are decided by a board whose members are all appointed by the government upon proposals from supervised entities and the Minister; its executives are appointed by the government and can be dismissed in cases of disagreement about policy or execution of the CSSF’s remit; and its statute confines the executives’ role to elaborating measures and taking decisions required to accomplish its missions.¹⁸¹

Yet another example is France, with regards to which the IMF noted that a representative of the Ministère de l’Economie et des Finances is present at the meetings of the boards of the French AMF and ACP as well as at the meetings of their enforcement committees. The IMF commented that this arrangement causes concerns regarding the independence of the financial supervisors in France, particularly given the power of the Ministerial representative to ask for a second deliberation on the supervisory matters being discussed by the board. Moreover, the IMF also noted that the board of the French supervisors is also composed of a number of industry representatives, which on the other hand raises concerns vis-à-vis independence from commercial interests.¹⁸²

However, concerns about interference in financial supervision by politicians are not only pertinent to Europe. In the US, agency independence from politicians is understood as independent of control from a single political party, but not necessarily independent from partisan politics.¹⁸³ This is different from the view of independence taken in Europe where agency independence would generally also refer to a certain degree of independence from the legislative and the executive authorities of government.¹⁸⁴ In this connection a concern has been expressed regarding the high degree of politicization of

¹⁸¹ IMF, ‘Luxembourg: Financial System Stability Assessment—Update’, June 2011 <<http://goo.gl/SaJPVx>> accessed 16.05.13.

¹⁸² IMF, ‘France: Financial System Stability Assessment’, December 2012 <<http://goo.gl/SaJPVx>> accessed 16.05.13.

¹⁸³ M Shapiro, ‘The Problems of Independent Agencies in the United States and the European Union’ (1997) 4(2) *Journal of European Public Policy* 267-291.

¹⁸⁴ D Geradin, ‘The Development of European Regulatory Agencies: What the EU should Learn from American Experience’ (2006) 11 *Columbia Journal of European Law* 38.

agencies such as the SEC.¹⁸⁵ In terms of its governing law, the SEC is headed by a bipartisan five-member Commission, comprised of the chairman and four commissioners, who are appointed by the President and confirmed by the Senate for staggered five-year terms.¹⁸⁶ By law, no more than three of the commissioners may belong to the same political party. In this manner independence is said to be achieved as the agency is not subject to the complete control of one political party.¹⁸⁷ Nonetheless, it has been observed that the appointed commissioners carry out their duties by applying a partisan approach, as the members generally embrace completely the philosophy of their political masters.¹⁸⁸ This has resulted in a concern that the operation of the SEC does not stand outside political domain and is being influenced by partisan politics.¹⁸⁹ Ultimately, appointments that are made purely on the basis of political patronage undermine the purpose of independence.

The involvement of political bodies in supervisory matters creates an environment, which is conducive to regulatory capture, with the clear risk that the financial supervisor may be unable to respond adequately to supervisory concerns should there be conflicting interests between the financial supervisor and its political master. This could undermine the financial supervisor's independence. Within the European context IMF assessments of Member States carried out during the years 2010 to 2012 raised concerns on the independence of financial supervision and/or the adequacy of resources for supervision with regards to eight out of twelve Member States.¹⁹⁰

On the other hand, the point has been made that a financial supervisory arrangement may suffer an accountability deficit, since the possibilities of control by democratically elected institutions may be limited.¹⁹¹ A democratically elected institution which

¹⁸⁵ F Norris, 'Independent Agencies, Sometimes in Name Only, New York Times (New York, 08.08.13)<<http://goo.gl/2XS7dw>>accessed 22.02.14. The criticism of the arrangements for independence of the SEC were discussed with Mr Robert Paze, former deputy director at the SEC. Mr Paze confirmed the allegations about the SEC's lack of independence from partisan politics.

¹⁸⁶ IMF(n148).

¹⁸⁷ R Bosworth-Davies, 'The SEC: An Examination of its Structure, Powers and Procedures' (1993) 2(1) Journal of Financial Regulation and Compliance 31-41.

¹⁸⁸ (n185).

¹⁸⁹ (n185).

¹⁹⁰ Concerns were raised by the IMF regarding the situation in: Romania; Sweden; Luxembourg; Czech Republic, France, Poland; Slovenia and Spain<<http://goo.gl/zd89MK>>accessed 16.05.13.

¹⁹¹ See amongst others: M Flinder, 'The politics of accountability in the modern state' (Ashgate 2001); and R Mulgan, 'Holding power to account: Accountability in modern democracies' (Palgrave MacMillan 2003).

operates in a complex and large public sector environment, may be acting as principal for a large number of agents. This widens the accountability deficit, as the attention for each of these agents may unsurprisingly be selective, as the time and attention at the disposal of the democratically elected institution would clearly be limited.¹⁹²

The cynical view has also been expressed that *accountability deficit* in financial supervision occurs because only some aspects of a financial supervisor's activity may have a bearing on a politicians' re-election chances in the short term. These include the extent to which new licenses have been issued that generate growth in a given economy and the degree to which financial services contribute to the general wellbeing of constituents. The political class will tend to focus their monitoring only on these aspects and will ignore the remaining activity of the financial supervisor, unless this becomes of political concern, such as where supervisory debacles occur.¹⁹³

Furthermore, the technical competence required in the field of financial supervision which the political class may lack, also contributes to the deepening of the accountability deficit as it is doubtful whether the political class would be in a position to assess properly the activity and performance of a financial supervisor.

In an environment where there is active cross-border business, a haphazard framework which regulates the governance of financial supervision at national level complemented by the traditional vertical forms of accountability are not enough to guarantee the legitimacy of a financial supervisor with its peers in other Member States. It is submitted that in the context of the internal market, unless robust standards for internal governance of financial supervision and horizontal accountability mechanisms are applied, financial supervisors may have mutual concerns about the standards and competence of their peers in other Member States.

Therefore, it would be optimal for mutual recognition based on a process of reflexive governance of financial supervision, if a European framework to regulate the standards of independence and accountability would be established together with standardised

¹⁹² T Schillemans, 'Remedies for the Accountability Deficit of Agencies: Does Horizontal Accountability Work? Evaluating Potential' (2011) 43(4) *Administration and Society* 397.

¹⁹³ T Moe, 'The new economics of organization' (1984) 28(4) *American Journal of Political Science* 767.

measures of the effectiveness of a financial supervisor and established mechanisms for horizontal accountability. European regulation of governance of financial supervision thereby becomes a potent tool in the process of strengthening mutual trust between financial supervisors.

The legal basis for such EU legislative measure which regulates the internal governance of a financial supervisor and which sets standards for measuring supervisory effectiveness may be based on Articles 114 or 115 TFEU. These regulate the adoption of EU laws that have the purpose of establishing and ensuring the functioning of the internal market. Such measures would have the objective of achieving a certain degree of uniformity in the governance of national financial supervisors and strengthening the quality of national supervision and by so doing enhancing mutual recognition between Member States.

Such a legislative measure would have to respect the principles of subsidiarity and proportionality. The regulatory framework would not go beyond stipulating the high-level objectives, values, constitutional arrangements and other internal organisational principles that ought to be respected by Member States with regard to the setting up and the on going functioning of financial supervisors. It should not interfere with the choice of an institutional model for financial supervision or the detailed governance arrangements relating to the operation of the financial supervisor.

The proposed framework would leave day-to-day supervision to be dealt with at national level, while creating high-level standards regulating the governance of supervision. These may be complemented by joint ESMA, EBA and EIOPA Level 3 Guidance for regulatory convergence. The latter could be another area where a process of reflexive governance of financial supervision could be appropriate. Discussion, mutual learning and the codification of best practices may be applied with a view to establish a number of possible options which could eventually be applied at national level for the implementation of the high-level standards on independence and accountability of financial supervision. The process could also be fruitful in creating guidance regarding the measures that may be applied in assessing the performance of a financial supervisor in the context of different types of financial systems. These would form the basis for horizontal accountability by way of peer reviews of national financial

supervisors coordinated by ESMA. This would present another opportunity for discussion and mutual learning on the best ways of addressing the high-principles for sound governance of financial supervision. The inherent outcome would be the further strengthening of mutual ties and respect among national financial supervisors.

5.5 Conclusion

Chapter 5 examined the substantive regime set in the 2009 UCITS IV Directive and the manner in which it achieves *quasi*-maximum harmonisation of the new areas of regulation covered by the Directive. The chapter argues and illustrates that *quasi*-maximum harmonisation of regulation is the optimal mechanism for the development of the regulatory framework for UCITS and should be applied for establishing a higher degree of harmonisation of the requirements on the authorisation, constitution and functioning of UCITS.

The chapter identifies the remaining limitations of the mechanisms for mutual recognition under the 2009 UCITS IV Directive and contends that the solution is not in the application of an even higher degree of harmonisation (the single rulebook mechanism) but in the approach to supervision. For this purpose, the centralised approach for European financial supervision and the mutual recognition approach based on coordinated and convergent national financial supervision have been considered.

The chapter argues that, in view of the nature of UCITS as a retail investment product that requires proximity of supervision to understand and cater for national cultural differences, the centralised approach would not respect the principles of subsidiarity and proportionality. The solution lies in strengthening the link between financial supervisors through a process of reflexive governance of financial supervision combined with a mechanism which guarantees the independence and accountability of financial supervisors at the national level, thereby strengthening mutual trust among national financial supervisors.

In the final analysis, the chapter maintains that in the context of UCITS an approach built on mutual recognition based on reciprocated trust, cooperation and convergent

supervisory practices is the optimal solution to the governance of supervision dilemma and for the completion of the internal market in this field.

Chapter 6

CONCLUSIONS

The internal market for UCITS operates on the basis of mutual recognition, which is contingent on harmonised regulation. The thesis examined the conditions and limitations of mutual recognition and sought to identify the *lacunae* in the governance mechanism and the regulatory framework for mutual recognition in the context of the UCITS Directive. It also identified and examined the regulatory and supervisory mechanisms that may be applied to address the identified weaknesses. The usefulness of this approach is that it examines the different models that have been implemented, and new mechanisms that may be applied, with a view to resolving the governance of EU financial regulation and supervision dilemma, particularly within the context of the UCITS Directive.

The thesis formulated a theoretical framework for effective mutual recognition based on *quasi*-maximum harmonisation, reflexive governance of financial supervision and a mechanism for the strengthening of mutual trust between national financial supervisors.

Harmonised financial regulation, which seeks to achieve homogenous investor protection on a cross-border level, has been and still is the most important mechanism which is applied by policy-makers to allow mutual recognition of financial regulation of UCITS between Member States, thereby allowing the creation of an internal market in this field. The nature of UCITS as a retail investment product which may be created under different legal forms based on specific legal traditions in Member States, requires an approach to regulation that achieves a high degree of harmonised investor protection while allowing flexibility to address national differences.

The technique for financial regulation in the field of UCITS must, as a consequence, create the right balance between implementing a policy designed to attain the common good through a high degree of harmonisation of substantive law, while making exceptions to address differences at national level. The picture that emerged from the

analysis in the thesis is one in which a model based entirely on minimum harmonisation causes serious limitations to mutual recognition in the form of inconsistencies in the application of EU regulation and the application of national discretions. *Quasi*-maximum harmonisation becomes the optimal harmonisation technique for UCITS.

Under the *quasi*-maximum harmonisation regime, maximum harmonisation is applied in those instances where complete homogeneity and consistency are required to achieve a high degree of investor protection, while leaving minimum harmonisation to those areas of regulation where flexibility is critical in order to respect the distinct legal traditions and cultural differences at national level. Within the context of the functioning of the internal market in a field of regulation where maximum and minimum harmonisation of regulation coexist, instances of maximum harmonisation become a mechanism for the strengthening of the overall mutual recognition between Member States, as it reinforces mutual trust between these States in areas which are exceptionally important for accomplishing the objectives of financial regulation.

The analysis determined that the limitations of a model based on minimum harmonisation of regulation resurfaced, although to a lesser extent, even in the framework based on *quasi*-maximum harmonisation. In the circumstances, however, the solution does not lie in the adoption of an even higher degree of harmonisation of substantive regulation of UCITS (the single rulebook mechanism), but lies in the approach to supervision. While mutual recognition which is contingent on *quasi*-maximum harmonisation of regulation is the key tool for the construction of the internal market in the field of UCITS, the European model for supervision becomes the critical ingredient to resolve the remaining barriers to cross-border business in this field. It is also the remedy to address the weaknesses of fragmented and inconsistent supervision that create opportunities for arbitrage, which damage the integrity of the internal market for UCITS by *inter alia* weakening mutual trust between financial supervisors.

The competing models for financial supervision, in the form of the centralised European approach to supervision and mutual recognition between financial supervisors, are the available options for the resolution of the European financial supervision challenge. However, given the nature of UCITS, the mutual recognition approach based on reflexive governance of financial supervision comes out as the best possible alternative

if the principles of subsidiarity and proportionality are to be respected. Reflexive governance of financial supervision perceives diversity in supervisory practices in Member States as the basis for experimentation and mutual learning which may prove to be critically important for the overall process of European integration. This together with a framework for the strengthening of mutual trust between national financial supervisors can form the basis for overcoming the remaining obstacles to the cross-border activity of UCITS, including the barrier to the depositary passport which is the last major bastion that stands in the way of a complete internal market for UCITS.

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Annex 1

LIST OF INTERVIEWS

Regulators

Balaban Marian, Capital Markets Specialist - Romanian National Securities Commission [CNVM]

Comporti Carlo, Secretary General – Committee of European Securities Regulators

Conthe Manuel, Ex Chairman – Spanish Securities Regulator [CNMV]

Conti Vittorio, Vice Chairman – Italian Securities Commission [CONSOB]

Hellwagner Robert, Deputy Head of Division – Prudential Supervision of Collective Investment Undertakings – Austrian Financial Market Authority [FMA]

Hulst Pieter, Officer – Dutch Financial Market Authority [AFM]

Kirppu Paula, Market Supervisor – Finland's Financial Supervisory Authority [FIN-FSA]

Mercieca Karl, Ex Manager – Malta Financial Services Authority [MFSA]

Plaze Robert, Ex Deputy Director of the Division of Investment Management of the US Securities and Exchange Commission

Veraga Jorge Antonio, Deputy Director – Spanish Securities Regulator [CNMV]

Vestergaard Jens A, Financial Inspector - Investment Management Companies and UCITS Division - Danish Financial Services Authority

Wandel Esther, Policy Officer – European Commission

Industry

Agius Joseph, Head of Custody – HSBC Bank Malta plc

Baillie Kirstene, Partner – Field Fisher Waterhouse LLP

Barnes Ian, Executive Director – J.P. Morgan Bank Luxembourg SA

Chetcuti Dimech Frank, Managing Partner – CDF Advocates

De Domenico Adam, Managing Partner – Zodiac Advisory Services

Geaghan Mike, Chief Officer – PVE Capital LLP

O'Driscoll Anthony, Managing Director – Apex Funds Services Limited

Pulpon Daniel Alonso, Managing Director – FCS Assets Management Limited

Swan Giles, Director - ICI Global, Ex-Policy Officer at the UK Financial Services Authority

Wharton Michael, Director / Compliance Officer - Alpstar Capital Limited

Annex 2

INTRODUCTORY E-MAIL AND LIST OF QUESTIONS

“Dear Sir/Madam,

I refer to our telephone conversation. Thank you for accepting to participate in a semi-structured interview.

As discussed, in terms of the research ethics regulations of the University of Sussex, I am required to provide all participants with information about the thesis and the interview. The purpose of this e-mail is to satisfy the applicable conditions in this regard.

This document is divided into five sections as follows: Section 1 provides information about the thesis. Section 2 explains the manner in which the semi-structured interview will be carried out and how the data from the interviews will be used and stored. Section 3 outlines some of the questions that will be asked during the interview. Section 4 is the consent form.

I would appreciate if you could: [i] carefully consider the content of this document; [ii] specifically confirm that you would like to participate in the interview; and [iii] indicate a date that is convenient to you when the interview may be held.

Section 1: Information about the thesis

Title: The development of the EU regulatory and supervisory framework applicable to UCITS: A critical examination of the conditions and limitations of mutual recognition.

Purpose: The purpose of the thesis is to examine how the conditions for mutual recognition have evolved through the different stages in the development of the EU framework for the regulation and supervision of financial services, with particular reference to the UCITS Directive.

It is also the purpose of the thesis to examine how the different conditions for mutual recognition have contributed to the overcoming of identified regulatory and supervisory obstacles to cross border business of UCITS. This requires an examination of the historical and current regulatory and supervisory conditions that have caused and, in some instances, are still bringing about certain restrictions to the completion of the internal market for UCITS.

The thesis also has the purpose of making suggestions regarding future reform to the EU regulatory framework and governance of supervision, which should address the remaining regulatory and supervisory obstacles to a complete internal market for UCITS. It also seeks to establish the extent to which future reform may encourage more widespread investment in this type of financial product across borders.

Section 2: Information about the semi-structured interview

The purpose of the interview is that of obtaining further evidence about the remaining regulatory and supervisory barriers to the cross border activity of UCITS and their service providers and to assess the validity of proposed solutions to overcome these barriers.

Subject to your consent, the interview will be carried out by way of a telephone call [or a meeting] on a date that is convenient for you. The interview should take between thirty minutes and an hour, during which the topics and questions outlined in section 3 will be discussed.

The information obtained during the interview will be used to support the statements and arguments made in the thesis. In this regard, subject to your consent, your name and designation will be disclosed in the thesis.

During the interview you will be granted with the opportunity to consent separately to different components of the semi-structured questionnaire. You will also be granted with the opportunity to make ‘off the record’ or anonymous observations. Two days after the interview you will be provided with a copy of a transcript of the interview and asked to check and confirm its content.

The information obtained during the interview will ONLY be used for the purpose of the thesis and relevant academic articles. It will be used for NO other purpose without your prior approval. It will be stored in the author’s personal computer and will not be disclosed to third parties. Access to the author’s personal computer is secured with a password, which is not available to any third parties. The content of the thesis and academic publications will, however, be available to the public.

Please note that you have a right to withdraw from the interview at any time. Until the date set for the submission of the thesis, you will also have the right to withdraw the information provided during the interview by sending an e-mail to the following address cpbuttigieg@gmail.com .

Section 3: Topic and Questions

Topic

Mutual recognition between Member States in the field of financial services was and still is the main tool that is applied by the EU institutions to overcome regulatory and supervisory barriers to the creation of an internal market for UCITS. Mutual recognition in the field of financial services has two dimensions: regulation and supervision. Mutual recognition functions on the basis of harmonisation of regulation, regulatory convergence and the convergence of supervisory practices. Mutual recognition is not the only tool for removing regulatory and supervisory barriers to cross-border business.

The extent of mutual recognition between Member States in the field of financial services depends on the realisation of a certain degree of harmonisation of EU financial regulation, the consistent implementation of EU regulation by Member States, and the

convergence of supervisory practices through supervisory cooperation between Member State competent authorities responsible for financial supervision.

The central argument of the thesis is that while a blend of European and national regulatory and supervisory mechanisms has been adequate for building the foundations of a broad internal market for UCITS, national agendas, regulatory arbitrage and supervisory arbitrage have made mutual recognition an ineffective tool for removing the remaining regulatory and supervisory barriers to the internal market for UCITS.

Mutual recognition is not the only tool that may be applied for the purpose of removing regulatory and supervisory barriers to cross border business. The thesis contends that to overcome the remaining regulatory and supervisory barriers to cross-border business in the field of UCITS, mutual recognition should be complemented by other mechanisms, such the establishment of a partial single rulebook for UCITS, the adoption of a single supervisory manual and delegated/shared/centralised European supervision.

As evidenced by the 2012 UCITS VI Consultation, the UCITS internal market project is far from being concluded. This document asks for stakeholders' views on the operation of the UCITS with regards to the assets, which are eligible for investment by UCITS, the lack of an internal market passport for depositaries and the regulation of other aspects of the operation and investment by certain types of UCITS. It also consults on whether the requirements on consolidation mechanisms and the passporting mechanism for UCITS might require improvement.

Moreover, the competition between Member States to attract the establishment of financial institutions to their jurisdiction for eventual cross-border marketing across the EU, has generated a supervisory race to the bottom. This has resulted in different definitions of what can be categorized as a UCITS in the EU.

Supervisory arbitrage has been on the EU policy makers' agenda. These have expressed the concern that fragmented national supervision was leading to supervisory arbitrage, and was providing incentives to national financial supervisors to compete via lax supervisory standards and practices to avoid putting national industry in a less competitive position or out of fear that some institutions would shift part of their business to less strict supervisory systems.

Concern about competition between Member State financial supervisors and lax supervision and supervisory arbitrage weaken mutual trust between financial supervisors. This has, in turn, resulted in the implementation and application of non-harmonised national marketing rules in a way that prohibits certain types of UCITS from being marketed in their jurisdiction. It has also resulted in a repeated rejection by Member States of proposals for the adoption of a depositary passport. This, with the aim of protecting their industry on the one hand, while keeping out undesired UCITS structures on the other.

Questions

The identified four major remaining regulatory and supervisory barriers that hinder the completion of the internal market for UCITS are:

[a] Inconsistent Application of the Directive: The inconsistent application of the requirements on the type and quantity of asset classes, which are eligible for investment by a UCITS. An asset may be eligible for investment by UCITS in one Member State but not in another Member State.

[b] National Marketing Rules: In terms of the UCITS Directive Member States can adopt their own regulatory and advertising regimes for the marketing of a UCITS. The application of national marketing rules by the host Member State means that UCITS have to cope with various local distribution requirements if they intend marketing in several Member States. In certain instances national marketing rules have been/are applied by Member States to restrict the type of UCITS that may be marketed on their territory.

[c] Depositary Passport: The lack of a passport that gives depositaries access to the internal market. Repeated attempts to introduce a depositary passport have failed in view of lack of harmonised regulation of depositary eligibility criteria, functions and standards of civil liability in case of failure and also due to the apparent significance of proximity of supervision.

[d] A General Failure of Supervisory Convergence and home-host country supervision: Member State Competent Authorities still apply different approaches to the supervision of UCITS and their service providers. Home-host country supervision increases the regulatory burden on UCITS and may also result in the failure of supervision to react promptly in addressing supervisory concerns.

The following ten questions have the purpose of serving as general guide for the discussion to be held during the interview.

Q1. Do you generally agree with the identified list of regulatory and supervisory obstacles to the completion of an internal market for UCITS? Are you aware of any additional regulatory and supervisory barriers to the cross border activity of UCITS and their service providers?

Q2. The inconsistent application of the Directive by Member States has resulted in situations where assets that are considered as eligible in one Member State are ineligible in others. Do you agree that this state of affairs harms mutual recognition between Member States?

Q3. More consistency in the application of the requirements on eligible assets may be achieved through the application of a maximum harmonisation approach to regulation i.e. creating a single rulebook for UCITS eligible assets. Do you see this as a suitable solution to achieve a higher degree of consistency? Is this required to strengthen mutual recognition between Member States with regard to UCITS?

Q4. Do you agree that the application of national marketing rules increases the regulatory and supervisory burden for UCITS, which market their units across borders? Do you see this as a major barrier to the cross-border activity of UCITS?

Q5. Is regulatory convergence the right approach to achieve more consistency with regard to national marketing rules? Or is this an area where harmonisation of regulation

is the appropriate solution?

Q6. The requirement that the depositary must be in the same Member State as that of the UCITS prohibits the provision of cross-border depositary services. It may be argued that this puts those Member States where the depositary industry is not developed at a disadvantage, as it would naturally give rise to inefficiencies within the local depositary business. This, at the detriment of the UCITS established in those Member States and ultimately the investors. Do you agree?

Q7. Would a depositary passport generate competition and consequently a higher degree of efficiency within the depositary industry?

Q8. The proposed UCITS V regime, together with the proposed MiFID II and CRD IV, create a suitable regulatory framework and the degree of harmonisation, which is necessary to allow the application of a depositary passport. Do you agree? In the negative, what additional regulation do you believe would be necessary to allow mutual recognition in this field?

Q9. Concern about the adequacy of cross-border supervisory arrangements, has been one of the major stumbling blocks to an agreement for a depositary passport. It may be argued that existing mechanisms for supervision in different fields, such as the single European supervisor approach applied to credit rating agencies and the proposed ECB/national supervisors model for banks which is currently being debated at the level of Council, may be considered in order to ensure a consistent level of supervision for depositaries. What are your views?

Q10. Since fiscal responsibility in case of the failure of a depositary lies within that depositary's home Member State, supervision should also be located there. Do you agree with this statement? Do you see this as a major stumbling block to the development of a more European approach to the supervision of depositaries?

Section 4: Consent

Please confirm that you would like to participate in the interview. Please also confirm that the information provided during the interview may be used for the purpose of the thesis together with your name and designation.

Please note that the researcher will have the final say over what is included in the thesis or other academic publications.”