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Europe Prepares for a Single Financial Market

A single market in financial services has long been an objective of the European Union. In 1999, the Commission launched the Financial Services Action Plan (FSAP), an ambitious programme to integrate capital markets by 2005. This article gives an overview of the progress made so far and the tasks which still need to be tackled.

Despite the internal market and Economic and Monetary Union, the EU economic and trade area is still incomplete since it lacks an integrated internal market for services. However, it is in particular the integration of financial markets which is of vital importance for the economic development of the European Union. It will result in a more efficient and more stable financial system. The resulting increased liquidity and broader range of financial products will benefit all market participants. According to the Commission study on the "quantification of macroeconomic impact of integration of EU financial markets", the reduction in the user cost of capital and in trading costs could lead to an EU-wide increase in GDP of approximately 1.1% or €130 billion over the next decade, which is equivalent to a per capita increase of €350. Total business investment would increase by 6% in the long run, private consumption by 0.8% and total employment by 0.5%. Our capital markets constitute the key to economic growth and to the EU's global competitiveness. An integrated financial market would thus promote the objectives of the Lisbon Summit held in 2000 to make the EU the most competitive economic region in the world.

However, even five years after the launch of Monetary Union and two years after the successful introduction of euro notes, Europe continues to lack a completely integrated, efficient, fast and secure financial market and proper cross-border competition. The fact that trading in securities internationally is more expensive and takes more time than doing business within one country is neither politically nor economically acceptable. In 1999, the European Union established an ambitious programme to integrate capital markets by 1 January 2005. The European Parliament, in particular the Economic and Monetary Committee, and the Council have already adopted 40 of the 42 legislative and non-legislative measures in the Financial Services Action Plan (FSAP).

The European Parliament has made consumer protection in financial services a high priority in order to counter a widely held belief among consumers that it is difficult for them to enforce their rights and to seek compensation in this area of the single market. This sentiment was expressed in the September 2002 Eurobarometer survey on the public opinion of financial markets: "Consumers continue to feel powerless in relation to financial services providers – 65% believe that they will never win in a dispute with an insurance company or bank, 60% believe that you can never be sure of your insurance cover, 50% find mortgage credit offers incomparable and are convinced you never know the cost of a (consumer) credit in advance".

To complete the internal market a sound framework for internal corporate governance is required in order to restore investor confidence and guarantee the stability of financial markets. Rules and the appropriate supervision are vitally important in order to restore investor confidence following the most recent scandals. This is the key to stable financial markets.

The committee has always been open to all market participants and civil society for input to its reports and legislative work in financial services. It has organised numerous hearings to take account of new evidence and different opinions. In 2002 the Committee estab-

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lished a panel of ten independent financial experts to advise on the package of measures outlined in the FSAP in order to help the Committee to ensure that high-quality legislation is put in place. The Parliament is also directly involved in monitoring the functioning and effectiveness of the Lamfalussy Process, dealing with the secondary legislation of FSAP legislation. It does so, inter alia, by its nomination of two representatives to the Inter-Institutional Monitoring Group (six independent experts nominated by Council, Commission and Parliament) on the Lamfalussy Process.

State of Play

Some of the most important measures which the European Parliament had been able to adopt included the directives on financial conglomerates and market abuse/insider trading. The *Directive on Financial Conglomerates* is intended to prevent conglomerates from using the same capital to cover risks in different areas of business, notably bank and insurance activities. The need for this had arisen as a result of the creation of large international financial groups active in different financial sectors: without a single European standard, a potential loophole could have arisen with regard to the supervision of such conglomerates. The directive therefore considerably enhances financial stability. The *Market Abuse Directive* can be seen as a milestone in the promotion of the integrity of financial markets. Scandals in recent years have had a lasting detrimental effect on investor confidence in the financial markets. The purpose of the directive is to increase protection for investors and to render the EU capital markets safer and more attractive. The aim is to set standards for market integrity, to harmonise regulations throughout Europe aimed at preventing market abuse, to establish a binding obligation to ensure transparency and equal treatment of all market participants and to promote cooperation and greater exchange of information between state authorities. This will serve considerably to reduce some of the existing loopholes and inconsistencies in the national legislations.

The *Collateral Directive* aims at regulating collateral arrangements (both for cash and securities) in credit transactions, in particular repurchase arrangements, between companies in different Member States. The European Parliament was able to introduce considerable improvements for SMEs. It was possible, thus, to extend the scope of the directive so that it not only covers financial institutions, public bodies and large enterprises, as originally provided for in the Commission proposal, but also SMEs. The *IAS Regulation* of June 2002 constituted a considerable step towards uniform and transparent accounting practices in Europe. In addition, this promotes the integration of financial markets by assuring the comparability of undertakings behind individual financial products.

The *Pension Fund Directive* aims to create for the first time an EU-wide legal framework for pension funds for occupational retirement provision. It allows an undertaking active in several EU Member States to offer all its employees an occupational retirement pension with the same basic conditions. This should result in considerable savings in administration costs and thus encourage companies to provide supplementary pension funds for their employees. Moreover, the directive constitutes an important step towards guaranteeing the mobility of workers within the European Union. In addition to the employee's right to be informed, the optional inclusion of biometric risks and a guarantee that sums paid out should always be adequate to provide a lifelong pension are of vital importance to the European Parliament.

The *Prospectus Directive* harmonised the information which an issuer or his issuing bank must provide for potential investors in the form of a formalised prospectus. The disclosure rules are to be harmonised to the point that issuers can be provided with a "European passport" so that an issuer will be able to check only one prospectus to be provided for investors instead of fifteen. The European Parliament insisted in the freedom of choice of regulator for the issues of bonds worth more than €1000.

The European Parliament made a considerable contribution to achieving a sensible balance between the interests of issuers and the protection of investors. Thus, as a result of the pressure, a sensible compromise was reached with regard to the controversial question as to the authorising authority, a question of importance to the smaller Member States. A prospectus should provide transparency as regards the opportunities and risks of the securities described so as to allow an informed decision to be made. Parliament ensured that each investor be given the most important information in a summary of the prospectus drawn up in the language of his/her country. Such a provision of clear and comprehensible information constitutes a considerable gain in transparency for private investors in particular.

In December 2003, the Council and the European Parliament were able to come to an agreement as re-

gards a *Takeover Directive*. The aim will be to create a European framework for company takeovers and to provide sufficient protection for minority shareholders. In view of the significant differences that exist between the business cultures and company laws in the various Member States, the extremely difficult negotiations resulted in only a barebones compromise with numerous optional elements.

The new proposal for an *ISD directive* is of particular importance as it seeks to create a level playing-field with regard to the transactions in securities and other investment services in Europe. The EU financial market has become a great deal more complex since the entry into force in 1993 of the Investment Services Directive. The line between regulated markets and the services of investment firms is now less clear. As a result of progress achieved in the area of information technology, alternative trading systems (ATS) and in-house trading systems of banks (internalisation) have started offering what was hitherto the core business of stock exchanges. There are more market participants and more trading possibilities. But there are different financial market cultures. Internalisation could lead to a splitting of liquidity. There is therefore the risk that the volume traded on the regulated market will shrink to such an extent that effective price formation would no longer be possible. The price information provided by the regulated market would then be of only limited value. For this reason, we need strict transparency requirements also for in-house trading systems of banks. These transparency provisions should also comprise a certain level of pre-trade transparency. This is necessary in order to stimulate competition and to give investors the choice of the best trading system. This would promote both market efficiency and the protection of investors.

Finally, Parliament was able to reach a "last-minute" compromise with the Council. I regard the agreement that has been found as a good compromise, which suits both exchanges and investment firms. It will provide a fair framework for them to operate. In particular two crucial questions could be solved.

- Regarding the definition of "standard market size": shares will be grouped in classes on the basis of the average value of the orders executed in the market for that share. The standard market size for each class of shares will be a size representative of the arithmetic average value of the orders executed in the market for the shares included in each class of shares.
- Regarding "price improvement": investment firms have been given opportunities to execute orders by their professional clients at a better price in justified cases, but they are not allowed to do so in the case of retail clients. There must not be any discrimination between individual retail clients as not all of them have sufficient insight into market practices.

A further important legislative procedure that could have been finalised in March concerns the permanent *transparency* requirements for issuers of securities traded on regulated markets. This is important because high quality, comparable information for investors in Europe not only serves to promote the integration of financial markets and cross-border capital investments but also facilitates a better functioning of financial markets and results in a higher level of protection for investors. These are all objectives to which the European Parliament has always felt committed. One of the controversial points in the proposal for a directive was the planned introduction of obligatory quarterly reports. However, these could prove to be an incentive for short-term profit maximisation for the purpose of "window dressing" and this cannot be the aim of the directive. Companies should aim at a long-term increase in their real value. In addition, such reports constitute a financial burden in particular for SMEs without providing any visible added value for investors. What is important to investors is not the quantity but the quality of information. This is particularly so for small investors.

A significant proportion of companies already publish quarterly reports, in part due to national provisions, in part voluntarily, mostly in order to meet the criteria for inclusion in certain sectors of the stock exchange. This again raised the question as to the need for a legal obligation, and in particular one provided for by European law. Consequently, the compromise achieved between Council and Parliament leaves this point to national discretion and offers companies the possibility of voluntarily submitting to stricter disclosure requirements, as may be common practice in certain sectors. All other companies are just required to issue interim statements which comprise a more general description of the firm's financial development.

As regards the creation of new capital adequacy standards *("Basel II")* and their implementation through a European directive, the European Parliament emphasised in its resolution that there was a need to reform the antiquated capital adequacy provisions. However, it warned that provisions should not be excessively

complex so as to keep the costs of implementation to acceptable levels even for smaller institutes. It also drew attention to the need to avoid the threat of disadvantages for start-ups and for SMEs, in particular as regards the provision on financing involving equity holdings and the valuation of securities. Further measures were deemed necessary against the danger of pro-cyclical effects on the real economy.

The 1999 Financial Services Action Plan will require additional individual directives or packages of measures. A particular priority must be the creation of a single area for mass payments and the clearing and settlement of securities transactions. It is particularly urgent that the Financial Services Action Plan be complemented with the creation of a *single area for mass payments*, a Single Euro Payments Area (SEPA). The European Parliament must champion the interests of its citizens. Moreover, it is impossible to make citizens understand why it should be that small cross-border payments in a unified Europe are still more complex, expensive and time-consuming than national payments. We need coherent legal provisions in the area of payments, covering all aspects of the transactions involved in mass payments, notably as regards the cost, time required and safety of payments. Similarly, the improvement of technical security of payments and, in this connection, also, the question of legal certainty are also a major priority. It is of great importance that consumer friendly provisions are adopted with regard to “refunds” and “burden of proof”. Standards also need to be harmonised. This would pave the way for Europe-wide payments on the same basis as national payments.

Extension of the Lamfalussy Process

Legislation on the financial markets is adopted under the co-decision procedure which means that the Council and the European Parliament must come to an agreement on the basis of a Commission proposal. If there is no agreement at the common position stage or at the second reading of the European Parliament, the conciliation procedure is launched, the results of which must be approved at third reading. In order to expedite legislation on highly complex technical matters, consideration was given to delegating the legislative powers of the Council and European Parliament by the introduction of the Lamfalussy procedure. The Lamfalussy procedure comprises a complex four-level structure, which goes from framework legislation to the enforcement phase of Community law. The Committee argues that technical points in financial services legislation often turn out to be extremely political, hence the importance of transparency and consultation at all stages. Although the Lamfalussy procedure appears to be logical, sensible and easily comprehensible, experience to date with the ongoing process of legislation in the area of securities is not yet convincing. It has proven to be somewhat difficult to distinguish between “political” and merely “technical” issues. Since Parliament is not allowed to influence legal provisions from level 2 onwards, it cannot accept that issues of political importance are decided there.

The political process requires democratic control. However, under the current agreements of the Lamfalussy procedure the balance has shifted to the disadvantage of Parliament, which consists of democratically elected members. That this is so is due to the fact that to date no secondary legislation has been adopted. The EU Treaties must be amended to ensure that the Council and Parliament have the same level of control as regards the adoption of level 2 provisions. Within the co-decision procedure, the Council and Parliament have the same rights as regards the formulation of basic legal provisions and it is therefore totally illogical that only the Council should, as is presently the case, be entitled to influence level 2 provisions. The draft Constitution takes an important and appropriate step with its proposed provisions under Article 35 (delegated regulations). Unfortunately, it was not possible to come to a final agreement on the Constitution at the Brussels Summit in December 2003 and it is unclear when a new attempt will be made to do so. In view of the extension of the Lamfalussy procedure beyond the field of legislation on securities to cover other sectors of legislation on financial markets, the European Parliament therefore called for clear assurances regarding a proper institutional balance between Council, Commission and Parliament until the planned provisions of Article 35 come into effect.

This is essential to ensure proper democratic supervision at all stages of the legislative process. Within the co-decision procedure, the Parliament and Council have equal say over basic legislation, and it is illogical that only Council should be granted extra powers that the Parliament does not have. The secrecy of the thousands of comitology procedures is unacceptable for systems subject to democratic parliamentary scrutiny.

Parliament voted in favour of the extension of the Lamfalussy procedure under the following conditions:

- the institutional balance and the rights of Parliament must always be guaranteed as declared by Commission and Council on 31 March 2004;
- the Member States must seek to adopt the text of Art. 35 of the draft Constitutional Treaty for delegated legislative provisions in order to respect the institutional balance between Council and Parliament;
- the implementing measures which are adopted must not modify the essential provisions of Directives;
- the European Parliament must be given a period of 3 months to allow it to give its opinion on the implementing measures;
- there will be a review of the Lamfalussy extension by the end of 2007.

Additionally, the transparency of the whole process urgently needs to be enhanced to guarantee sufficient participation by all interested groups, particularly retail investors.

Legislative procedure is an instrument to translate voters' demands into laws. It must be a transparent, understandable and controllable process that cannot be completely left to opaque committees that have never been selected by the electorate.

EU - USA: Areas of Conflict and Dialogue

The two largest economic areas in the world, the EU and the USA, are in many respects closely intertwined: major companies often compete on the same markets, equity participation and stock market listings of European companies in the USA and vice versa are commonplace. Direct investments in the USA held by European investors totalled some US$ 870 billion net in 2001 with those of US investors in the EU totalling some US$ 630 billion. Subsidiaries of US companies employed some 4.1 million people in the EU while EU companies were directly responsible for the creation of as many as 4.4 million jobs in the USA. Transatlantic capital flows and investments thus constitute the most important interconnections in the world. Promoting and developing them further will be of vital importance for the world economy. Moreover, the stability of financial markets is directly affected by these massive capital flows. This means that there is a need to coordinate legislation as regards economic matters, notably with regard to supervision and regulation in the globalised sector of financial services.

The EU rightly wants to see further steps towards a convergence of the *International Accounting Standards (IAS)* and the *US Generally Accepted Accounting Principles (US-GAAP)*. It is essential for investors to be able to compare companies on both sides of the Atlantic using the same yardstick. The European Parliament is convinced that the IAS, an internationally agreed method based on principles, is significantly better suited to the various differing business cultures than the partly case-based US-GAAP. As things stand, there is the additional burden of double reporting for European companies quoted on US stock markets. In order to avoid this in future, the EU is rightly calling on the SEC to recognise accounting pursuant to the IAS at least for these companies. We need a specific timeline for this.

The EU is also calling for EU stock exchanges to be allowed to provide US brokers and investors with remote access to their trading platforms by placing *trading screens* in the USA without the need to go through a complex procedure to register the trading platform and the securities traded thereon with the SEC. This is legitimate since EU regulations are no less strict than those in the USA. It is therefore to be welcomed that for the first time there seems to be some positive movement. SEC chairman Donaldson has given express assurances that this issue will be resolved by mutual consent. We are now calling on the SEC to take specific steps to do so.

The European Parliament welcomed the adoption of the *Sarbanes-Oxley Act* to assure investor and consumer protection. However, this legislation also has an impact on the European economy, European companies and European auditing and legislation. One of the central demands of the EU in this respect is that we are not prepared to place European auditors under the regime of the "Public Company Oversight Board" established as a follow-up to the Sarbanes-Oxley Act. The required registration constitutes an unreasonable burden for European auditors and is unnecessary since sufficient measures are taken in EU Member States to assure the quality of auditors.

The European Parliament expressly supports the *constructive dialogue* which already exists between the Commission, the Treasury, FED and SEC and, now also, the CESR. We need to create an atmosphere of trust in order to achieve progress. However, this dialogue needs to be accompanied by regular talks at a political level, notably with the participation of the US Congress and the European Parliament in order to defuse potential areas of conflict at the earliest opportunity. The globalisation of markets makes international dialogue and coordination necessary.