


1993

# Securities Law in the European Community: Harmony or Cacophony?

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## Recommended Citation

1 Tul. J. Int'l & Comp. L. 3 (1993)

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# SECURITIES LAW IN THE EUROPEAN COMMUNITY: HARMONY OR CACOPHONY?

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## I. INTRODUCTION: THE UNREALIZED 1992 SINGLE SECURITIES MARKET

The Treaty of Rome, which laid the foundation for the European Communities (EC) in 1958, was designed to remove all restrictions on the free movement within the EC of goods, persons, services and capital.<sup>1</sup> This grand plan was furthered by the European Commission White Paper of 1985, which set forth a program for creating a single European market by 1992 which would be

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1. TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [EEC TREATY], art. 3(c).

expanding and flexible, to ensure that resources, including capital and investment, would flow into the areas of greatest economic advantage.<sup>2</sup> It was envisioned that national regulators would continue to play a supervisory role, but that financial services would be liberalized by putting into effect EC-wide minimum standards which would supersede former national regulations.<sup>3</sup> A timetable for the adoption of securities law directives was included in the White Paper.<sup>4</sup> The White Paper was then implemented by the Single European Act amendments to the Treaty of Rome, which encouraged and facilitated the use of directives to harmonize the laws of Member States.<sup>5</sup>

The objective of these efforts was to remove technical barriers, that either added costs or restricted entry into particular markets, thereby impeding the free movement of goods, services, (natural and legal) persons and capital. This open internal market was intended to give consumers access to a wide range of financial products, without regard to the country from which they were provided, to make the financial services sector more competitive and capable of utilizing economies of scale and to provide discipline in the conduct of economic policies. A single financial market would serve to encourage rational investment and allocation of savings throughout the EC. Further, the single market envisioned would set up an attractive and competitive integrated financial system for both EC and non-EC business circles.<sup>6</sup>

Nevertheless, it was recognized that there was a need for EC-wide prudential rules to underpin the stability of the financial system and to provide a satisfactory level of protection for consumers.<sup>7</sup> The mechanism chosen for integration of the financial markets was a series of directives that would harmonize essential standards throughout the EC and enable financial regulators

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2. Completing the Internal Market: White Paper from the Commission to the European Council, COM (83) 310 final at ¶8 [hereinafter White Paper].

3. *Id.* at ¶103.

4. *Id.* at Annex, 26-27.

5. Single European Act, Feb. 17, 1986, 1987 O.J. (L 169) 1005, 25 I.L.M. 506 [hereinafter SEA]. A directive is not a law, such as the Treaty of Rome, which directly applies to EC Member States and supplants national law. Rather, the directive requires Member States to take such legal measures as may be necessary in order to achieve and aim of the EC within a specified time. A directive is not self-operating; it is more like a uniform law, that requires implementation by each Member State. See, KLAUS-DIETER BORCHARDT, *THE ABC OF COMMUNITY LAW* 27 (1990).

6. White Paper, *supra* note 2, at ¶125-27.

7. 1992: *Completion of the Single Market in Financial Services*, Commission of the European Communities, 1 SEC/B16/88, Oct. 10, 1988.

to practice home country control, but oblige them to honor principles of mutual recognition.

At the end of the first half of 1992, as the Presidency of the EC passed from the Portuguese to the British, the single market program in financial services was woefully behind schedule. Major directives were either languishing from lack of interest or so controversial they could not go forward in a meaningful form. Further, an ambitious private sector initiative to integrate the securities markets had failed. This article will describe what progress had been made on harmonization of the securities laws in the EC by the middle of 1992 and then set out some theories on why greater harmonization proved so difficult.

On a superficial level, public and private sector politics can be blamed for the impasse in securities law harmonization, but the political forces at work have deep economic and historical legal roots. These forces are related to the conflict between governmental centralization in Brussels and subsidiarity which is at the heart of the debate over the Maastricht Treaty.<sup>8</sup> However, certain factors peculiar to the securities markets have made financial integration an intractable problem. First, there are different systems of corporate finance in different European countries which are difficult if not impossible to reconcile without strong pressure from investors and such an investor constituency does not yet exist in Europe. Second, securities regulation in Europe has developed in an insular fashion. In some countries regulation has traditionally been governmental, while in other countries it has been market based. At a time when stock exchanges all over the world are engaged in a battle for survival resulting from rapid technological changes, no one is deeply interested in experimenting with new regulatory regimes.

Part II of this article will describe the EC securities and company law directives relevant to the creation of a single EC securities market. Part III will describe competing European models for corporate finance and stock exchange trading. Parts IV and V will analyze why some directives have passed but other major proposed directives remain pending, perhaps for the indefinite future. Finally, the author will suggest that a single EC securities market is unlikely to be realized, regardless of the outcome of ratification of the Maastricht Treaty, until a powerful consumer group, such as institutional investors, demand integration of the European capital markets.

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8. See Mark Nelson, *EC Summit to Mull Concept of Subsidiarity*, WALL ST. J., June 26, 1992, at B6.

## II. THE SECURITIES AND COMPANY LAW DIRECTIVES

Financial services law encompasses, at a minimum, the law applicable to public and private offerings of securities and the regulation of financial markets and financial intermediaries. In the United States, banking, commodities and insurance law are considered as disciplines separate from securities law, and this article maintains that distinction, although portions of the Second Banking Directive<sup>9</sup> are relevant to understanding the progress of securities law harmonization.

The United States also separates securities law, which is primarily federal law, from corporation law, which is primarily state law. In Europe, corporation or company law similarly is viewed as distinct from securities law, although some harmonization of company law was also part of the 1992 program. There is a serious question as to how far harmonization of securities law can proceed without harmonization of company law because these two fields of law are both complimentary and conflicting. Furthermore, the role and protection of shareholders is very different in the United Kingdom than in continental Europe. Company law and securities law come together in the area of takeover regulation, which was on the 1992 agenda for the single market, but about which there is little consensus.

The first step in creating a single market in financial services was the liberalization of capital movements, permitting both individuals and firms the freedom to invest capital anywhere in the EC; for example, the right to open a bank account in any Member State.<sup>10</sup> Although this freedom allows an investor to take the initiative and approach suppliers of financial services, it does not insure that the suppliers are free to establish and solicit business from potential investors in every EC country. In order to create an EC-wide capital market that would not imperil the stability of the financial system, the EC determined that a level playing field should be established for financial suppliers and users; for example, uniform rules for stock exchange membership or harmonized capital adequacy requirements for banks and securities firms. A series of directives eliminating technical barriers to cross-border securities offerings and trading was therefore put forward.

There are four groups of financial law directives which relate to the

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9. Council Directive 89/646, 1989 O.J. (L 386) 1, amended by Council Corrigenda of Mar. 30, 1990, 1990 O.J. (C 42/06) 7.

10. This objective was accomplished by the adoption of the directive liberalizing controls on capital movements. Council Directive 88/361, 1988 O.J. (L 178) 5.

efforts to develop a single securities market in the EC. These groups consist of directives on financial disclosure, directives covering public securities offerings and stock exchange listings, directives regulating trading markets, and directives regulating financial intermediaries. Another way to analyze the types of law required to create a comprehensive scheme of securities regulation is to determine what rights should be granted to and what obligations should be imposed upon each of the three groups affected by securities laws: issuers seeking capital, investors and financial intermediaries.

An important series of directives have been adopted setting forth minimum standards for the protection of shareholders of all EC companies. These directives also protect creditors, including bondholders and suppliers. For the most part, these directives cover both public and private companies and regulate financial disclosure and related matters. The First Directive on Company Law<sup>11</sup> provides a system of publicity for all companies and requires disclosure of information on their basic corporate documents, officers, and balance sheet items, such as paid-up capital and profit and loss accounts. The Second Directive on Company Law<sup>12</sup> applies only to public companies and specifies minimum capital requirements, lays down certain restrictions on issued share reacquisitions and provides for shareholder preemptive rights.

The Fourth Directive on Annual Accounts<sup>13</sup> requires that annual financial statements be published that give a "true and fair" view of a company's assets, liabilities, financial position and profit and loss. Two formats for the balance sheet and four formats for the profit and loss account are permitted. Guidelines are provided for the presentation of standard minimum footnote disclosure. The Sixth Directive on Divisions<sup>14</sup> requires that certain types of restructuring be approved at an annual meeting and affords shareholders informational and fair treatment rights. The Seventh Directive on Consolidated Accounts<sup>15</sup> specifies when accounts have to be consolidated and the procedures for doing so. The Eighth Directive on Auditor Qualification<sup>16</sup> lays down minimum educational and professional qualifications for auditors of public companies and provides that auditors should be persons of good repute. The Eleventh Directive on Company

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11. Council Directive 68/151, 1968 O.J. SPEC. ED. (L 65) 41.

12. Council Directive 77/91, 1977 O.J. (L 26) 1.

13. Council Directive 78/660, 1978 O.J. (L 222) 11.

14. Council Directive 82/891, 1982 O.J. (L 378) 47.

15. Council Directive 83/349, 1983 O.J. (L 193) 1.

16. Council Directive 84/253, 1984 O.J. (L 126) 20.

Law<sup>17</sup> standardizes the information a Member State can require a local branch of a foreign company to disclose so that branches of foreign companies can be treated in the same manner as domestic branches.

One important directive in the field of company law has not been passed. The Amended Proposal for a Fifth Directive on Company Law<sup>18</sup> deals with the structure of corporate boards and is highly controversial. It was initially proposed twenty years ago and could easily remain only a proposed directive into the next century.

A second group of directives establishes standards for disclosure in public offerings and listings of securities. The Admissions Directive<sup>19</sup> sets forth minimum requirements for the admission of shares and debt securities on Member State stock exchanges. The Listing Particulars Directive<sup>20</sup> requires that, prior to being listed on a stock exchange, companies provide investors with a prospectus containing all information necessary to make an informed assessment of the assets and liabilities, financial position, profits and losses and prospects of the issuer and of the rights attaching to the securities. The Interim Reports Directive<sup>21</sup> imposes an ongoing requirement on stock exchange listed companies to publish semi-annual profit and loss reports and developments of significance to investors. The Public Offer Prospectus Directive<sup>22</sup> regulates public offerings of transferable securities throughout the EC, either by the issuer or selling shareholders. Specific items of information disclosure are mandated and exemptions are provided for small issues and private placements.

These minimum disclosure standards provide a foundation for imposing an obligation on securities regulators to recognize the disclosure regulatory standards of other EC Member States. An amendment to the Listing Particulars

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17. Council Directive 89/666, 1989 O.J. (L 395) 36.

18. Amended Proposal for Fifth Directive Founded on Article 54(3)(g) of the EEC Treaty Concerning the Structure of Public Limited Companies and the Powers and Obligation of Their Organs, 1983 O.J. (C 240) 2. A related effort is the proposed Statute for the creation of a European company. Amended Proposal for a Council Regulation (EEC on the Statute for a European Company, 1991 O.J. (C 176) 1.

19. Council Directive 79/279, 1979 O.J. (L 66) 21, *as amended by* Council Directive 82/148, 1982 O.J. (L 62) 22.

20. Council Directive 80/390, 1980 O.J. (L 100), *amended by* Council Directive 82/148 (L 62) 22, *and* Council Directive 1990 O.J. (L 112) 24.

21. Council Directive 82/121, 1982 O.J. (L 48) 26.

22. Council Directive 89/298, 1989 O.J. (L 124) 8.

Directive<sup>23</sup> provides that EC Member States must recognize stock exchange listing applications of issuers from other Member States without requiring additional information, if an application filed simultaneously (or contemporaneously) is approved by the issuer's home state. The Second Mutual Recognition Directive<sup>24</sup> provides for similar mutual recognition of any public offer prospectus which has been subject to scrutiny and approval by a competent authority. The workings of these directives demonstrate the principles of minimum standards, mutual recognition and home country control, that are basic tenets of the single market in securities.

A third group of directives deals with securities trading. The Major Shareholdings Directive<sup>25</sup> requires disclosure to the issuer and to competent authorities of significant acquisitions or dispositions of listed securities. The Insider Dealing Directive<sup>26</sup> harmonizes the law on insider trading and requires all Member States to adopt legislation to prohibit insider trading. Of possibly more far reaching importance than either of these directives is the Proposed Thirteenth Directive on Company Law<sup>27</sup> that would establish minimum standards for the conduct of takeovers. This directive is extremely controversial because it goes to the heart of corporate governance and therefore is unlikely to move forward in the immediate future.

A fourth group of directives addresses the regulation of financial intermediaries. The Second Banking Directive<sup>28</sup> establishes a legal framework for a single banking market in the EC to begin on January 1, 1993. It provides that a bank established and licensed in one EC Member State may provide financial services throughout the EC without obtaining additional regulatory approvals in other EC states. This right to establish branches in other EC countries, and to market and sell services in any country directly, without being required to obtain a license from the host country, is often referred to as the single passport. Although banks are subject to home rather than host country control, minimum capital adequacy and other standards are set forth in the

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23. Council Directive 87/345, 1987 O.J. (L 185) 81.

24. Council Directive 90/211, 1990 O.J. (L 112) 24.

25. Council Directive 88/627, 1988 O.J. (L 348) 62.

26. Council Directive 89/592, 1989 O.J. (L 334) 30.

27. Amended Proposal for a Thirteenth Council Directive on Company Law Concerning Takeover and Other General Bids, 1990 O.J. (C 240) 7.

28. Council Directive 89/646, 1989 O.J. (L 386) 1, *amended* by Council Corrigenda of Mar. 30, 1990, 1990 O.J. (C 42/06) 7.



Second Banking Directive as a predicate for mutual recognition. The Second Banking Directive is relevant to this article for two reasons. First, in some, but not all European countries, banks are stock exchange members and dominate the securities industries. Second, the Second Banking Directive is a model for a single passport for securities houses, that thus far has not been achieved.

The UCITs Directive<sup>29</sup> sets forth minimum standards for what Americans call mutual funds and what Europeans call Undertakings for Collective Investments in Transferable Securities. The effect of the directive is that any closed-end investment fund within an EC Member State that complies with EC minimum standards and has been duly authorized by the appropriate home country regulator can be freely marketed throughout the EC without prior authorization of the host country. The proposed Investment Services Directive<sup>30</sup> would establish a single passport for securities firms, but has long been bogged down in controversies concerning what, if any, minimum standards for regulation of stock exchanges and securities intermediaries should be a predicate for such mutual recognition. The related proposed Capital Adequacy Directive<sup>31</sup> would establish financial responsibility requirements for securities firms.

### III. COMPETING MODELS OF CORPORATE FINANCE

The individual EC Member States have developed very different forms of public company and stock exchange organization. These differences can be attributed to a variety of economic, political and cultural forces. Of paramount importance is the role of the public securities markets, with the stockholder as a legal surrogate, in funding and ordering business, as contrasted with the role of either banks or the government. Also relevant is how the tension between capital and labor is resolved.

In the United Kingdom, directors manage corporations essentially for the benefit of shareholders.<sup>32</sup> Although recent legislation has imposed a duty upon

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29. Council Directive 88/220, 1988 O.J. (L 100) 31.

30. Commission Proposal for a Council Directive on Investment Services in the Securities Field, 1989 O.J. (C 43) 7 [hereinafter *Investment Services Directive*].

31. Commission Proposal for a Council Directive on Commission Proposal for a Council Directive on Capital Adequacy of Investment Firms and Credit Institutions, 1990 O.J. (C 152) 6. *Capital Adequacy of Investment Firms and Credit Institutions*, 1990 O.J. (C 152) 6.

32. *Percival v. Wright*, 71 Ch. 846 (1902); *Hutton v. West Cork Railway Company*, 23 Ch.D. 654, 671 (Ch. Div'l Ct. 1883). See generally, P.A.R. Brown, *The Role of Independent Directors in Corporate Governance*, 56 NOTRE DAME L. REV. 936 (1981).

directors to employees of the firm,<sup>33</sup> labor-management tensions are resolved through collective bargaining rather than within the firm's corporate governance structure. The public securities markets are a significant factor in the funding and ordering of financial structures.<sup>34</sup> Institutional investors, including pension funds, are an important force in the stock market.<sup>35</sup>

Under the German system of co-determination, employees are represented on the supervisory board of the corporation and have as great a claim to corporate profits as shareholders. Commercial banks are major shareholders of the most important public companies, so lenders, rather than shareholders, take the lead in allocating capital.<sup>36</sup> Hostile takeovers are rare.<sup>37</sup> Institutional investors are not very significant.<sup>38</sup> The corporate governance system in the Netherlands is similar to that of Germany, but institutional investors play an influential role in the equity market.<sup>39</sup>

In France, the government is significantly involved in corporate finance. Companies frequently are financed by affiliated companies as well as by banks.<sup>40</sup> Individual share ownership has been encouraged in recent years, both directly and through collective investment funds. A new shareholder protection regime has gone hand in hand with a policy of privatization of government enterprises.<sup>41</sup> Other so called "Club Med" countries, such as Italy and Spain,

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33. Companies Act, 1985, § 309 (Eng.).

34. Jeffrey R. Knight, *Reform and Change in the European Stock Exchanges*, in THIRD PHIROZE JEEJEEBHAY MEMORIAL LECTURE, Dec. 4, 1991, at 33. See JULIAN WALMSLEY, *GLOBAL INVESTING* 223-30 (MacMillan Press Ltd. 1991).

35. Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1, 12 (1991). See also Victoria Younghusband & Ian Wilson, *United Kingdom*, in INTERNATIONAL CORPORATE GOVERNANCE 227 (Joseph C.F. Lufkin & David Gallagher eds., 1990).

36. 4 RICHARD M. BUXBAUM & KLAUS J. HOPT, *LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE* 181-82 (1988); JANET DINE, *E.C. COMPANY LAW* § 8.3 (1991); *New Dreams at Deutsche Bank*, *ECONOMIST*, June 22, 1991, at 79.

37. Hermann H. Kallfuss, *The American Corporation and the Institutional Investor: Are There Lessons from Abroad? The German Experience*, 3 COLUM. BUS. L. REV. 775, 784 (1988).

38. Buxbaum, *supra* note 35, at 13-14.

39. Gils van Leeuwen, *The Netherlands*, in INTERNATIONAL CORPORATE GOVERNANCE 171, 171-76 (Joseph C.F. Lufkin & David Gallagher eds., 1990).

40. See COLLIN RANDELSOME, *BUSINESS CULTURES IN EUROPE* 60, 80 (1990).

41. See John J. Duffy, *Are Banks Ready for French Revolution?*, *AM. BANKR.*, Apr. 20, 1987, at 1; *French Stock Market Reform; Big Bang Encore*, *ECONOMIST*, Sept. 14, 1991, at 90.

have similarly organized economies.<sup>42</sup>

The stock exchanges in Europe also have different characteristics. In the United Kingdom, the stock exchange is an important part of the economic and financial fabric of the country. There is a strong tradition of self-regulation and a respect for free market forces.<sup>43</sup> The London Stock Exchange is a quote driven market and off-exchange trading is possible. Universal banking is permitted.<sup>44</sup> The Netherlands and Denmark adhere to this model, except that the Amsterdam Stock Exchange has a unique trading system, which is order driven and employs a specialist (called a *hoekman*) to establish trading prices.<sup>45</sup>

In Germany, the stock exchanges have long been dominated by the banks, which engage in off-exchange trading. The equity markets are decentralized and relatively weak.<sup>46</sup> Since exchange members are almost exclusively banks, they are regulated as such. This model also prevails in Luxembourg.<sup>47</sup>

In contrast to both the United Kingdom and Germany, the Napoleonic model is one of institutional rigidity. All orders must be brought to the stock exchange and an official price is set once a day by a designated stock exchange broker.<sup>48</sup> In France, Italy and Spain until very recently, this official was appointed by the government.<sup>49</sup> In these countries, banks may own stock brokerages, but they cannot become direct stock exchange members.<sup>50</sup>

The legal systems of the United Kingdom and the continental countries are also at odds. In the United Kingdom there is a common law system in which a significant portion of company and securities law is based on judicially developed theories of fiduciary duty. The British strongly prefer financial self-

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42. RANDESOME, *supra* note 40, at 107-08, 133-35, 238-39.

43. Knight, *supra* note 34, at 33.

44. See *Five Years Since Big Bang; After the Earthquake*, *ECONOMIST*, Oct. 26, 1991, at 23.

45. Jorgen Gronborg, *Denmark*, in *INTERNATIONAL CORPORATE GOVERNANCE*, 81, 86-87 (Joseph C.F. Lufkin & David Gallagher eds., 1990); *Government Delays Securities Transaction Supervision Act*, *INT'L SEC. REG. REP. (BNA)* No. 5, at 5 (Mar. 24, 1992). Amsterdam generally is considered the first stock exchange; shares in the Dutch East India Company were traded there. See FERDINAND BRAUDEL, *THE WHEELS OF COMMERCE* 100-106 (1979).

46. WALMSLEY, *supra* note 34, at 244-46.

47. Knight, *supra* note 34, at 32-33.

48. *Id.* at 32.

49. See *La grande boum*, *ECONOMIST*, Oct. 11, 1988, at 83; *Far Reaching Changes on the Bolsa*, *WALL ST. J.*, Apr. 28, 1992, at B6.

50. ROGER D. HUANG & HANS R. STOLL, *MAJOR WORLD EQUITY MARKETS: CURRENT STRUCTURE AND PROSPECTS FOR CHANGE* 30 (1991).

regulation to statutory regulation, viewing the latter as insufficiently flexible.<sup>51</sup> On the Continent, a civil law system covers company law and securities law, and financial regulation proceeds from theory to actuality. Perhaps too much is made of this distinction, since the Germans also favor self-regulation and the United Kingdom in recent years has developed a detailed statutory regime to regulate the securities industry.<sup>52</sup>

There also is a wide range of models for governmental agencies regulating the securities industry. This has become an important issue in the implementation of EC directives, because a competent authority to supervise particular activities, for example the review of prospectuses, must be designated when national laws are passed. In countries with a strong self-regulatory tradition, such as the United Kingdom, the Netherlands and Germany, stock exchanges have been designated as competent authorities and they act pursuant to delegated governmental power.<sup>53</sup> In France, Italy, Spain and Portugal, independent agencies have been created to oversee securities activities and intermediaries.<sup>54</sup> In Belgium, a new agency supervises both banking and securities.<sup>55</sup> In Germany, there is no federal securities supervisory authority. For this reason, among others, the Insider Trading Directive has not yet been implemented.<sup>56</sup> Indeed, one of the most important consequences of EC securities law harmonization has been the creation of new securities regulators. However, since countries have responded so differently to implementation of the enacted directives, this proliferation of administrative agencies may impede rather than facilitate future progress toward the adoption of EC-wide standards.

Finally, the problems of language and culture should be mentioned. All EC documents must be produced in the language of each Member State, although negotiations could be more expeditiously conducted in one language. However,

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51. BUXBAUM & HOPT, *supra* note 36, at 190.

52. See Charles Abrams, *The U.K. Financial Services Act 1986*, REV. FIN. SERV. REG., June 3, 1987, at 101. See generally Bernhard Grossfeld, *The Internal Dynamics of European Community Law*, 25 INT'L LAW. 124 (1992), for an argument that the EC is moving U.K. law closer to continental law.

53. *International Equity Offers*, International Organization of Securities Commissions 21-22 (1989).

54. *Id.* at 22; Francesco Corsi, *Recent Developments in Italian Corporate Law*, in JURIDIFICATION OF SOCIAL SPHERES 273, 278, 284-85 (Gunther Teubner ed., 1987).

55. BUXBAUM & HOPT, *supra* note 36, at 189.

56. See David Waller & Katharine Campbell, *Germans Call for Tougher Rules*, FIN. TIMES, Dec. 20, 1991, at 24; *Finance Ministry Releases Plans to Revamp Securities Laws; Exchanges Reach Agreement*, INT'L SEC. REG. REP. (BNA) at 1 (Jan. 27, 1992).

language itself is traditionally a very political matter in Europe.<sup>57</sup> Also, while the northern countries generally are less enthusiastic about Europe as an organizational ideal than the southern countries, they are quicker and more conscientious about implementing directives.<sup>58</sup> Furthermore, business cultures and the education of business leaders differs from country to country, which impedes the development of a European business culture.<sup>59</sup>

#### IV COMMENTS ON THE ADOPTED DIRECTIVES

Implementation of the disclosure and accounting directives appears to have had only a minor effect on financial disclosure by world class companies. Very generally, the accounting directives bring accounting standards throughout Europe up to the more rigorous standards previously followed only in countries such as the United Kingdom and the Netherlands. However, world class issuers were already listed in London or on other major stock exchanges.<sup>60</sup> Moreover, the EC directives still allow considerable choice, so that EC accounting principles cannot be considered up to an international standard.<sup>61</sup> Finally, the EC directives did not regulate the use of huge hidden reserves by German and some other continental companies, which means that the financial statements of issuers of different countries, or even within the same country, are not necessarily comparable.<sup>62</sup>

Hidden reserves enable companies to utilize their cash flows for self-financing without the need to tap public securities markets. They also lower

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57. Existing logistical difficulties will increase if the EC admits more numbers. *See On the Way to the Forum*, *ECONOMIST*, July 11, 1992, at 14.

58. *See* Andrew Kennon, *The Single Market -- A Legislative Perspective*, 13 *COMPANY LAWYER* 25, 30-31 (1992).

59. *See* Lucy Kellaway & Tim Dickson, *Painful Birth of Single Market*, *FIN. TIMES*, Dec. 19, 1990, at 16; *The Business of Europe*, *ECONOMIST*, Dec. 7, 1991, at 63.

60. It has been estimated that 40% of the trading volume in many major European stocks takes place on SEAQ International in London. Richard E. Rustin, *London Spawns Market of the Future - for Big Players*, *WALL ST. J.*, Oct. 25, 1990, at C1, C9.

61. *See* Bob Hagerty, *Differing Accounting Rules Snarl Europe*, *WALL ST. J.*, Sept 4, 1992, at A4; David Waller, *Bringing Harmony to the Babel of Community Accounting Languages*, *FIN. TIMES*, Oct. 16, 1989, at 6.

62. Jonathan Fuerbringer, *World Market; S.E.C. Says No on German Stocks*, *N.Y. TIMES*, Apr. 26, 1992, at 15; *See* David Waller, *Germans Draw Line at Two Sets of Accounts*, *FIN. TIMES*, Mar. 19, 1992, at 33. *See also*, *All the World's a Ratio*, *ECONOMIST*, Feb. 22, 1992 at 72.

taxes. Because accounting for tax purposes and financial disclosure purposes is identical in some countries, such as Germany and Italy, but not in others, such as the United Kingdom and the Netherlands, it is difficult to develop market-oriented international accounting standards.<sup>63</sup> Also, the EC directives on auditor qualifications did not set forth independence standards for auditors.<sup>64</sup>

The directives did make a difference at the edges, particularly with regard to consolidation principles.<sup>65</sup> Also, they had a significant impact on privately owned companies that heretofore had no obligation to publicly report their assets or earnings. The disclosure and accounting directives will prove at least as helpful to bank lenders, and even to trade creditors, as they will to shareholders.<sup>66</sup> This may have been a critical factor in the political compromises that were reached regarding these directives. The directives probably will facilitate economic integration within Europe, and they may prepare privately held companies in countries like Italy for future public offerings, but their immediate impact on the financial disclosure practices of listed companies has been minimal.

The mutual recognition provisions of the listing particulars and public offer directives held out more promise of creating a single market in securities and generally improving financial disclosure. This has not happened, however, due to the rivalries and suspicions of the European stock exchanges, which will be discussed more fully in connection with the Investment Services Directive.<sup>67</sup> It should be noted that the mutual recognition provisions are very narrow; they only come into play in the instance of simultaneous or virtually simultaneous listing applications. There is no obligation for a stock exchange in one country to list an issuer because it is listed on an exchange in another EC Member State. The Eurolist project of the Federation of Stock Exchanges in the EC would result in this type of reciprocity, but the future of that project is uncertain.<sup>68</sup>

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63. Andy Simmonds & Olivier Azieres, *Accounting for Europe--Success by 2000 A.D.?* TOUCHE ROSS EUR. SERV. UPDATE 8-11, 44 (May 1989).

64. This was left to the decision making of each Member State. Council Directive 84/253, 1984 O.J. (L 126) 20.

65. See Simmonds & Azieres, *supra* note 63, at 45.

66. This is probably appropriate since the purpose of the harmonization is to remove barriers to the free movement of goods, persons, services and capital, not specifically to protect shareholders.

67. Investment Services Directive, *supra* note 30. See *infra* notes 85-98 and accompanying text for a discussion of the proposed directive.

68. See *EC Stock Exchanges Should be Linked, Not Merged, Federation Official Says*, [Jan.-June] SEC. REG. & L. REP. (BNA) No. 23, at 1004 (June 28, 1991).

Two of the adopted directives have the potential to be meaningful in the future. The UCITs Directive, which is in the process of being implemented, could create large cross-border investment funds which will lead to more efficient capital allocation. The managers of these funds may demand better financial disclosure and greater shareholder rights from European companies. The creation of large private pension funds in France and Italy, where there is serious government interest in supplementing retirement savings this way, could similarly lead to the development of a constituency favoring investor interests.<sup>69</sup>

The Insider Trading Directive may also prove a force for greater disclosure. If insiders are prohibited from trading on the basis of information known to them, but not publicly available, a system of continuous disclosure may develop more rapidly. In countries where banks are major shareholders of public corporations, the prohibitions against trading on inside information could change marketplace dynamics. It is difficult to understand how material information, such as the amount of a company's hidden reserves, will continue to be withheld from the market if this information is known to insiders.

## V COMMENTS ON THE STALLED DIRECTIVES

### A. *Company and Takeover Law*

Under corporate governance theories prevailing in the United Kingdom, shareholder interests are paramount. Shareholders are regarded as owners of the enterprise.<sup>70</sup> Labor relations are adversarial.<sup>71</sup> A board of directors owes a fiduciary duty to creditors only if a company is approaching insolvency.<sup>72</sup> By contrast, large public corporations in continental states all have some degree of

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69. In both France and Italy, pensions are funded on a pay as you go system. With an aging population, such financing is infeasible and accordingly plans are being made for the creation of funded pensions. Alice Rawsthorn, *Re-engineering the Paris Stock Market: A New Wave of Changes to French Securities Rules*, FIN. TIMES, Mar. 24, 1992, at 23; *Houdini Meets His Match*, ECONOMIST, July 18, 1992, at 73.

70. PETER XUEREB, THE RIGHTS OF SHAREHOLDERS 10-11 (1989).

71. David Marsh, *Competing with Germany: A Hard Act for Britain to Follow*, FIN. TIMES, Apr. 15, 1991, at 14.

72. *Multinational Gas and Petrochemical v. Multinational Gas and Petrochemical Services Ltd.*, 1983 Ch. 258, 288 (C.A. 1983); *Insolvency Act, 1986*, § 214 (Eng.).

worker participation embedded in their corporate governance structures.<sup>73</sup> In Germany and the Netherlands, there are two-tier boards and employees are formally represented on the supervisory board.<sup>74</sup> Companies are not run primarily for the benefit of shareholders. Workers and other constituencies, such as creditors, also have a stake in a company's fortunes. Labor relations is not a separate branch of law, but a part of company law. This view of the firm stresses the continuity of the enterprise.<sup>75</sup>

These differences in perspective not only make for significant discrepancies in the company law of different EC Member States, but also create very different legal and business environments for hostile takeovers. Hostile takeovers are common in London and they are regulated by the Panel on Takeovers and Mergers, a self-regulatory body which operates pursuant to the City Code on Takeover and Mergers (City Code).<sup>76</sup> The two most important principles in the City Code are that the shareholder of an offeree company must decide whether or not an offer should succeed, and that all equity holders must be treated equally.<sup>77</sup> In addition, after an offer is communicated to the board, or even if a board has reason to believe an offer is imminent, the offeree board is prohibited from taking any action without the approval of shareholders at a general meeting "which could effectively result in any bona fide offer being frustrated or in the shareholders being denied the opportunity to decide on its merits."<sup>78</sup>

On the Continent, hostile takeovers can occur, but they are not actively

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73. Demitris Constat, *The Developing European Community Law of Worker Participation in Management*, 11 INT'L LAW & POL. 93 (1978).

74. Friedrich K. Kubler, *Institutional Owners and Corporate Managers: A German Dilemma*, 57 BROOK. L. REV. 97, 98 (1991); J.J.M. Maeijer, *Dutch Law Relating to Hostile Takeovers and the Protection Against Them*, in DEFENSIVE MEASURES AGAINST HOSTILE TAKEOVERS IN THE COMMON MARKET 173, 190-95 (J.M.M. Maeijer & K. Geens eds., 1990).

75. See BUXBAUM & HOLT, *supra* note 36, at 177-81; M.J.G.C. Raaijmakers, *European Harmonization: Quo Vadis?*, in HARMONIZATION OF COMPANY AND SECURITIES LAW 64, 83-84 (1989).

76. See Jonathan Brayne, *Tender Offers Involving U.K. Companies*, 21 REV. SEC. & COMM. REG., 67, 70 (Apr. 27, 1988).

77. Simon MacLachlan & William Mackesy, *Acquisitions of Companies in Europe -- Practicability, Disclosure, and Regulation: An Overview*, 23 INT'L LAW. 373, 387-88 (1989).

78. The City Code on Takeovers and Mergers, Gen. Princ. 7 (Eng.).



encouraged by governmental policy or by financial institutions.<sup>79</sup> Numerous legal barriers to takeovers of a wide variety are permitted, although the types of barriers that are lawful and popular vary from county to county.<sup>80</sup>

In view of these very different perspectives on the role of management and directors, it is not surprising that both the proposed Fifth Directive on Company Law and the proposed Thirteenth Directive on Takeovers are controversial. The proposed Fifth Directive would mandate some form of worker participation in corporate governance; an anathema in the United Kingdom.<sup>81</sup> It also would, among other things, prohibit limitations on voting rights by large shareholders, and otherwise abrogate certain antitakeover devices.<sup>82</sup> Instead of serving to set up a viable political trade off, these pro-worker and pro-shareholder provisions have generated opposition from industrial companies everywhere.

The proposed Takeover Directive is similarly opposed both in the United Kingdom and on the Continent. Although modeled on the U.K. scheme of regulation and designed to protect shareholders, it would substitute a statutory regulatory system for a self-regulatory system. There are provisions for a mandatory bid once a threshold position of one-third of the voting shares are acquired. Also, all holders of an offeree company who are in the same position must be treated equally and the board of an offeree company is required to act in the interests of all shareholders by not frustrating the bid.<sup>83</sup> Although similar concepts are being introduced into French law, other continental countries are disinclined to leave their national corporations vulnerable to hostile takeovers by foreigners.<sup>84</sup>

In order to overcome the antagonism which the proposed Company Law and Takeover Directives have generated, a strong countervailing investor

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79. See COOPERS & LYBRAND, U.K. DEP'T OF TRADE AND INDUSTRY, 1 BARRIERS TO TAKEOVER IN THE EUROPEAN COMMUNITY §§ 1.5 - 1.6, at 2 (1989).

80. *Id.* §§ 2.29 - 2.35 at 22-24.

81. See John Gapper, *Fowler Attacks EC's Proposal to Enforce Worker Involvement*, FIN. TIMES, Oct. 23, 1989, at 12.

82. See Stephanie Cooke, *Lowering the Barriers to Euromergers*, INSTITUTIONAL INVESTOR, Apr. 1990, at 61; *Obstacles to Hostile Bids Are A Target of New EC Strategy*, [Jan.-June] SEC REG. & L. REP. (BNA) No. 22, at 909 (June 15, 1990).

83. 1989 O.J. (C 64) 8.

84. See *Takeover Directive Stalled; States Opt for Own Legislation*, INT'L SEC. REG. REP. (BNA) at 2 (Jan. 27, 1992); *Dutch Firms Warned on Takeover Exposure in a New Environment*, INT'L SEC. REG. REP., at 3 (Dec. 17, 1990).

constituency would be required. However, non-bank institutional investors in Europe are neither sufficiently large nor activist to counteract business managers and the banks, as major lenders, are unlikely to back measures which might destabilize company financial structures.

*B. The Investment Services Directive*

The Investment Services Directive was intended to provide a single passport for non-banking financial institutions to provide investment services throughout the EC. In addition, the Investment Services Directive was supposed to have been the vehicle for achieving the need, as perceived in the 1985 White Paper, to create a European securities market system based on EC stock exchange trading. The White Paper expressed the view that electronically linked stock exchanges creating a Community-wide trading system would substantially increase the depth and liquidity of EC stock markets, and ensure their satisfactory operation in the best interests of investors.<sup>85</sup>

Euroquote, a private sector initiative of the Federation of Stock Exchanges in the EC, would have created such a pan-European stock market.<sup>86</sup> However, the British viewed such an electronic exchange as a threat to SEAQ International, a trading system of the London Stock Exchange, and refused to finance it. As a result of the United Kingdom's opposition, the Germans also backed out of the project.<sup>87</sup> Eurolist, a much less ambitious project which merely facilitates the listing of world-class issuers on several EC stock exchanges, was substituted as a political compromise.<sup>88</sup>

The rival forces that destroyed Euroquote were then deployed to debates over the Investment Services Directive, which became stalemated. In order to understand these battles, it is necessary to understand the differences between SEAQ International and the continental stock exchanges. It is also necessary to appreciate that countries with universal banking, like Germany, where commercial and investment banking are conducted within a single entity, already

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85. White Paper, *supra* note 2, at ¶107.

86. See Richard Walters, *Pipe Brings Dream of Euro-bourse Closer to Reality*, FIN. TIMES, Apr. 19, 1990, at 36; *Plugging into a Pan-European Stock Market*, ECONOMIST, Mar. 10, 1990, at 81.

87. See Richard Walters, *Bourses Battle for Pride of Place in Europe*, FIN. TIMES, May 17, 1990, at 25; *Brussels Babble*, ECONOMIST, June 1, 1991, at 76.

88. Walters, *supra* note 87, at 26.

have a single passport to establish business in any EC country.<sup>89</sup> The only issue of importance to such universal banks is whether they can join stock exchanges.

SEAQ International is a screen-based quote-driven trading system that functions as an off-shore wholesale market in equity securities. It claims to handle up to half of the trading volume in big French and Italian equities and up to a third of the volume in big German stocks.<sup>90</sup> The continental exchanges, on the other hand, are order-driven and function as retail markets. In Germany off-exchange trading is permitted, but in France, Italy and other countries all orders are required to be brought to the stock exchange for execution.<sup>91</sup> Both quote-driven and order-driven markets have fervent supporters. Combining the two types of trading systems in a single market is technically and philosophically difficult.<sup>92</sup>

The initial draft of the Investment Services Directive embodied the principle of a single passport for securities houses, but had minimal provisions for the regulation of securities markets or intermediaries.<sup>93</sup> The French then came forward with amendments attempting to achieve minimum standards as to publication of trade information, off-exchange trading and access to stock exchange membership by banks.<sup>94</sup> This led to a North-South split, with the United Kingdom, Germany and the Netherlands arguing for latitude in the publication of trade information (to suit SEAQ International market makers), permission to engage in off-exchange trading (urged by the London Stock Exchange and the universal banks) and bank access to stock exchanges (of great importance to the German banks). France, Italy and Spain, more interested in protecting their national brokers and retail investors, fought for prompt public reporting of trade information, the prohibition of off-exchange trading and the restriction of stock exchange membership to securities firms (which could be bank subsidiaries). Although a political compromise was reached on these issues

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89. See Michael Gruson & Wolfgang Fuering, *The New Banking Law of the European Economic Community*, 25 INT'L LAW. 1 (1991).

90. *The Battle of the Bourses*, ECONOMIST, Feb. 1, 1992, at 81.

91. See *Setting Europe's Stockmarkets Free*, ECONOMIST, Sept. 7, 1991, at 18.

92. See *FIBV Workshop Addresses Issue of Secondary market Disclosure*, INT'L SEC. REG. REP. (BNA), at 5 (July 17, 1992); *Market Focus; Last Orders?*, ECONOMIST, Mar. 13, 1992, at 91.

93. Home country control was the rule. Capital adequacy was in a companion directive. See Marjory Appel, *EEC-1992 and the Securities Industry*, SEC. & COMM. REG. (Standard & Poor), Apr. 11, 1990, at 67.

94. See Andrew Hill, *Investment Services Reach Stalemate in Brussels*, FIN. TIMES, Mar. 15, 1991, at 29; *Struggling Through the Wire*, ECONOMIST, Aug. 3, 1991, at 69.

during the last days of the Portuguese Presidency, it is unclear what shape an EC directive will take that is capable of practical implementation.<sup>95</sup> A compromise on capital adequacy provisions was reached in conjunction with the decision to go forward with the Investment Services Directive.<sup>96</sup>

Stock exchanges all over the world are in the throes of change and modernization. Automation and internationalization have made traditional ways of trading stocks obsolete. Business efforts to integrate the European exchanges through a common quote system have failed and it is unlikely that EC law will be able to succeed in creating a European stock market.<sup>97</sup> While EC directives can remove barriers to competition and integration, it is much more difficult for the law to mandate ideal market place models.<sup>98</sup>

## VI. CONCLUSION

Financial regulation is generally slow and difficult. Such regulation necessarily strikes a balance between competition to promote efficiency and regulation to protect investors and to prevent systemic risks to financial institutions. Therefore, it is easy to stall reform. Perceived national self interest has made the achievement of a single market for European securities easier to debate than to achieve. Moreover, powerful special interest groups stand to lose more than they may gain by improved efficiency in the capital markets. What in the United States is sometimes viewed as a conflict between Wall Street and Main Street has international overtones in the EC. The financial community is interested in light regulation and the United Kingdom is interested in preserving London's status as a financial center.

Continental company managers fear threats to their hegemony from a market oriented corporate finance system, especially a system which encourages hostile takeovers. Stock exchanges have become fierce competitors and many

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95. See *European Financial Services; Delayed Harmony*, *ECONOMIST*, July 4, 1992, at 68.

96. See *Finance Ministers Reach Accord Setting Rules for Securities Brokers*, [July-Dec.] *SEC. REG & L. REP.* (BNA) No. 24, at 1004 (July 3, 1992).

97. See Richard Walters & George Graham, *Birth of a Market Needs Burial of Differences*, *FIN. TIMES*, Nov. 28, 1990, at 25; Richard Walters, *Bourses Build Up Defenses*, *FIN. TIMES*, Sept. 24, 1991, at 25; *International Equities: Trading Places*, *ECONOMIST*, Jan. 11, 1992, at 78.

98. Many of these same problems surfaced in the United States with regard to implementation of the national market system mandated by the 1975 amendments to the federal securities law. See Milton H. Cohen, *The National Market System - A Modest Proposal*, 46 *GEO. WASH. L. REV.* 743 (1978).

question their survival, especially regional continental exchanges. The London Stock Exchange is viewed as an unfair competitor because the regulation of SEAQ International is more lax than the regulation of domestic equity trading. Moreover, it has the characteristics of a derivative market.

The current impasse over the Company Law and Takeover Directives is unlikely to be broken unless some important business sector demands action. An Investment Services Directive is likely to be so riddled by political compromises that it will set no standards for stock exchange trading. The development of an institutional investor group of collective investment trusts and pension funds is the most likely constituency for securities law harmonization in Europe. At this time, however, investor activism in Europe is only inchoate.