What determines discretion in the national application of financial market regulation in the European Union?

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Fiete Starck
(s0195154)

Hirtenweg 78
18059 Rostock
Germany
Phone: 0049-381-4001016

University of Twente
Public Administration / European Studies

1st Supervisor: Dr. Shawn Donnelly
2nd Supervisor: Prof. Dr. Ramses A. Wessel

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UNIVERSITY OF TWENTE.

Abstract

This study answers the question "*What determines discretion in the national application of financial market regulation in the European Union?*". The motivation for that lies in explaining parts of the current financial crisis stirring up the European Union and the world. A cross-sectional comparative case study is undertaken, examining three key directives – the MiFID, the Prospectus Directive and the Transparency Directive – from the Financial Services Action Plan that is the foundation for European Union financial services regulation. This examination includes a thorough analysis of the creation and implementation of the directives across the European Union, identifying how much discretionary space they leave for the Member States. On the basis of two different theoretical approaches, this study explains where this discretionary space has its origins. It is found that the fact that MiFID and the Prospectus Directive are rather strict compared to the Transparency Directive covers the precedent preferences of the Member States. This proves bottom-up Europeanization to be correct, instead of principal-agent theory that assumes legislation leaves more discretion the less autonomous the supranational EU authorities are from the Member States. The changes and reforms undertaken to both the legislative and institutional framework of EU financial market regulation do not contribute to a change to this circumstance. Although it altered some of the procedures and assigned a larger set of powers to the supervising EU authority in the securities sector, the Member States are still able to keep the supranational authority on a short leash.

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List of Abbreviations

CESR	- Committee of European Securities Regulators
DG	- Directorate-General
EBA	- European Banking Authority
ECB	- European Central Bank
ECJ	- European Court of Justice
ECSC	- European Coal and Steel Community
EP	- European Parliament
ESC	- European Securities Committee
ESFS	- European System of Financial Supervisors
ESMA	- European Securities and Markets Authority
EU	- European Union
FMR	- Financial Market Regulation
FSAP	- Financial Services Action Plan
GAAP	- Generally Accepted Accounting Principles
IASB	- International Accounting Standards Board
IFRS	- International Financial Reporting Standards
ISD	- Investment Services Directive
MiFID	- Markets in Financial Instruments Directive
MS	- Member State/s
PD	- Prospectus Directive
QMV	- Qualified Majority Voting
TD	- Transparency Directive
TEU	- Treaty on European Union
TFEU	- Treaty on the functioning of the European Union

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1. Introduction

This study points out and explains discretion of the Member States of the European Union in the sector of financial market regulation.

As part of the internal market of the European Union (European Union, 2011a), financial market regulation was under supranational jurisdiction since the European Union was founded with the Maastricht Treaty in 1992 (European Union, 2010, p. 59). However, only with the launching of the Financial Services Action Plan in 1999 the EU undertook its first serious approach "to promote a fully integrated European capital market" by providing "the legal bedrock for EU financial markets' integration through uniform rules" (Lee, 2009, p. 4). Since this included negative integration by removing barriers to trade as well as positive integration by the establishment of new EU-wide legislation (Hix, 2005, p. 239), tensions emerged between the institutional powers of the European Union and the resistance of national regulators. On the one hand, economic integration promised access to a bigger market and external venues; on the other, being subject to supranational legislation and therefore political integration, likely loss of sovereignty was feared (Nugent, 2006, pp. 23-25). To complement the FSAP, a Committee of Wise Men was appointed to work out a more effective approach for formulating and implementing legislation in a field that requires so much expertise like the financial market. Named after the chairman of this committee, Alexandre Lamfalussy, the result is known as the *Lamfalussy framework* (Hartmann, Maddaloni, & Manganelli, 2003, pp. 205-206). Due to its importance for the matter, this framework will be explained in some detail later on. For now, it is important to know the core principles of this approach since they lead directly to the research question this paper is going to answer. The *Lamfalussy framework* intended to streamline and facilitate the creation and implementation of legislation for the financial market. In a multi-level approach, the Commission – acting, of course, on behalf of the Member States who delegated their powers to it – initiated a document containing framework principles for legislation which were then carved out to a detailed legal document by supervisory expert committees that ensure convergent implementation. The committees were composed of Member States' representatives from the Council of Ministers (European Securities Committee) and national regulating agencies (Committee of European Securities Regulators) (de Visscher, Maiscocq, & Varone, 2008, pp. 22-23). Therefore, despite the fact that the aim was a harmonized financial market environment in the European Union, the Member States and domestic actors still played an important role in creating and implementing financial market regulation.

With the beginning of 2011, however, the European system for financial market regulation was reformed. Regulation (EU) 1092/2010 subsumed the supervisory committees for banking, securities and insurances and occupational pensions under the new European System of Financial Supervisors[1]. Moreover, it created a European Systemic Risk Board acting as a macro-prudential supervisory authority and as the somewhat *head institution* of the ESFS. The reason for that was to tackle problems the financial crisis revealed. By paying bailouts and establishing rescue funding programmes to protect their citizens from the failures of financial service providers, national governments heavily stressed their finances which in turn negatively influenced budgets and debt development (Schäfer, 2009, p. 5).

[1] The *Lamfalussy Process* already created committees with comparable tasks. Regulation (EU) 1093/2010, Regulation (EU) 1094/2010 and Regulation (EU) 1095/2010 re-named them and gave them their new mandate.

One major point that was made when arguing about remedies for the crisis was that better coordination and cooperation of the EU's financial market policy would have softened the effects (de Larosière, et al., 2009, pp. 39-42; Sève, 2010, pp. 30-34). Hence, since the European Union already undertook some effort to harmonize and centralize their financial market policy as revealed in the former abstract, the findings just mentioned raise the descriptive research question this paper is trying to answer:

What determines discretion in the national application of financial market regulation in the European Union?

As will be shown later, although *per se* in the area under scrutiny supranational legislation prevails, loopholes existed that allowed the particular Member States to interpret EU law with regard to the degree of implementation. This is important because the financial market is part of the EU's single market, ought to be an area "in which people, goods, services, and capital move among Member States as freely as within one country" (European Union, 2011b). If, however, these loopholes outweigh the efforts made by enabling common legislation, then the target of market integration and harmonization was missed. This paper now wants to find out where these loopholes originated prior to the 2011 reform and what has changed to overcome this deficit.

To answer the overall research question, it needs to be identified where discretion actually stems from. That is, what kind of actors made use of which processes and institutions to create leeway for the Member States of the European Union in financial market regulation, and for what reasons. Moreover, we need also to be clear about how discretion for the Member States can occur. This leads to the sub-questions

1) *How does financial market regulation in the European Union come into existence?*
2) *In what ways can discretion for Member States in implementing financial market regulation occur?*

2. Analytical Framework I – The Institutional Development of the European Union

The research question of this paper focuses on the power of the Member States *vis-à-vis* the European Union. It tries to find out whether financial market regulation is truly dictated from above (the European Union) or still steered from below (the Member States). It is therefore worth to take a look at the nature of the responsible institutions. The institutional development of the European Union went from inter-state cooperation to, in most parts, supranational coordination. This can best be seen by the fact that, from the initial ECSC Treaty in 1951 to the founding of the European Union in Maastricht 1992, not only the policy areas under supranational responsibility have multiplied, but also that the more supranational qualified majority voting is today's dominant mode of decision-making (Nugent, 2006, pp. 211-215; 530).

However, whereas all legislation that is passed by the European Union goes through the same procedures (pp. 398-414), there is more to the institutional landscape than the Commission, Council, Parliament and Court of Justice. To regulate day-to-day business, the European Union created a bulk of agencies, committees and services representing the first instance at the European level in their respective policy area. In contrast to the institutions that are based solely on European authority, these bodies are fragmented, meaning that they are decentralized and work through the cooperation of national actors (European Union, 2011c).

Going back to the research question of this paper, it becomes obvious that it is worth to take a look at how the institutional set-up of the European Union's financial market regulation is. A dominance of fragmented institutions certainly gives room for Member States' discretion to influence legislation both during its creation and its implementation. To give a short introduction before the theory section will point out different hypothetical explanations, it is important to know that, at that point in time this paper is going to examine, both a European institution and a fragmented institution exerted considerable influence. On the one hand, the European Securities Committee represents the European side. It is composed of members of the Council, the Commission and the ECB and advised the Commission during the shaping of technical details for a legislative proposal under the *Lamfalussy framework*. On the other, the Committee of European Securities Regulators represents the fragmented side, consisting of the respective national financial regulating agencies, not only had the same advisory role like the ESC, but also plays a crucial role in the implementation of the new legislation (de Visscher, Maiscocq, & Varone, 2008, pp. 21-24).

In the following theory section, the institutional set-up for financial market regulation will be subject of the second hypothetical explanation. Additionally, in a later section on the analytical framework, a detailed description of the emergence of this set-up and its most important features will be given.

3. Theory

In the theory section of this paper, the analytical framework that surrounds the study will be pointed out. After an explanation of what is actually meant by "financial market regulation" in this paper, a conceptualization of "discretion" will be given. Then, alternative factors that determine discretion for the Member States in implementing EU legislation are described, based on the existing literature, leading to possible explanations that will serve as the study's working hypotheses.

3.1 Financial Market Regulation

The unit of analysis in this study is "financial market regulation in the European Union". Looking at the EU policy portfolio, one will not be able to find the category *Financial Market* (European Union, 2011d). This is not surprising because the financial market consists of several features: state budgets, central bank activity or the administration of private assets. Connected to these three admittedly very general headlines are *inter alia* taxation, customs, monetary policy, the activity of private banks, funds and insurances. Klein (2000) therefore groups the financial market into three categories: the money market, the *Kreditmarkt* and the capital market (pp. 19-23).

Table 1: *The Financial Market according to Christian Klein*[2]

	Actors	Traded Goods
Money Market	Central Banks, Banks	Short-termed loans, commercial papers
Kreditmarkt	central banks, banks, institutional investors, regional administration bodies, large corporations	middle- and long-termed loans (> 1 year), short-termed loans and commercial papers if at least one non-bank actor is involved
Capital Market	Sellers: corporations, banks, public authorities Buyers: funds, insurances, private investors	fungible long-term shares & stocks

In this paper, the term *financial market* will be used to describe activities on the capital market with regard to financial services. This means that the focus lies mainly upon private actors such as corporations, private banks, funds, insurances and private investors. The reason for that is that this paper tries to find out whether or not EU regulation designed for the "street level", for the activities of EU citizens, could fulfill its purpose of facilitating everyday life and create a truly European legal environment for private investors. Hence, the higher politics that concern state budgets and monetary policy will be left out. In addition to that, this paper considers "financial market regulation" as the shaping of the legal environment for actors on the financial market.

[2] Klein defines the different types of the financial market by the time limit that is inherent to the goods traded and the actors. In a broader sense his categorization would also allow actors from the *Kreditmarkt* to be involved in activity on the Money Market.

This happens through the enactment of laws that define conditions and standards for the conduct of business for financial firms, for instance capital and liquidity requirements or accounting guidelines (Handke, 2010, pp. 55-56). Activities outside this scope, like central banks' interest rate arrangements, can be considered as regulatory financial market policy, but non-regulation measures.

3.2 Discretion

The main concept of this study that needs to be clearly defined is "discretion". This paper is going to focus on discretion that is – borrowing the terminology from Delreux (2009, p. 271) – "granted" *ex ante* by the supranational legislation. In a short excerpt, this paper will also lay out basic assumptions how discretion can be "conquered" *ex post* by the Member States; this, however, requires another unit of observation and is, as will be explained later, also irrelevant for this study. "Granted" discretion can be found in the provisions given via the legislation and in the institutional set-up that safeguards its enforcement. Some EU legislation clearly defines not only the desired outcomes, but also the ways to get there, whereas other leaves it up to the Member States how to reach the objectives. Therefore, "discretion" here includes Member States' room to maneuver with regard to implementing legislation (Green Cowles, Caporaso, & Risse, 2001, p. 17). This room to manouevre includes both the leeway to reach a goal by differing means as well as the so-called "gold-plating" which refers to the practice of adding measures that exceed EU law (European Commission, 2012a). Knill and Lehmkuhl (2002, p. 264; 272) show that the distinction here does not necessarily has to be made between regulations as being stricter than directives. This approach uses EU legislation as the unit of observation. Excluded for this conceptualization is discretion as non-compliance with EU-desired policy outcomes. This "policy misfit", as coined by Börzel and Risse (2000, p. 5), would be a breach of EU law and hence falls outside the scope of this study.

3.3 Alternative Origins of Member State Discretion

To find out what determines discretion for the Member States of the European Union in implementing financial market regulation, we have to draw up a theoretical background to define the playing field. In the following, two different theories are pointed out that try to explain how room to manoeuvre gets incorporated into legislation, along with the derived hypotheses that match the research question. Because this study focuses on discretion granted *ex ante*, the main theoretical framework is liberal intergovernmentalism, focusing on how discretion is contained pre-structured in legislation based on the preferences of the Member States. According to Moravcsik (1993, pp. 481-482), negotiations at the EU level can be described as the intergovernmental bargaining among positions that the respective chief of governments took according to the aggregated preferences of their domestic actors based upon liberal theory. At the end of this two-level process, the agreements reached in Brussels "reflect the relative power of each Member State", with, if even existent, little causal influence by supranational institutions (Pollack, 2001, p. 225). Hence, liberal intergovernmentalism can be said to be at least skeptical about the true powers of EU authority. Based on this, bottom-up Europeanization and principal-agent theory develop two different hypotheses on what determines discretion in EU financial market regulation.

3.3.1 Europeanization

The first hypothesis is derived from the theory of Europeanization, a concept that embraces the interactions of the European Union and its Member States or, respectively, third countries, including states being subject to the European Neighborhood Policy and accession countries. Europeanization comprises a top-down dimension ("downloading"), seeking to explain how domestic change is caused by the European Union, a bottom-up dimension that deals with particular states and domestic actors and how they can "shape EU policies, EU politics, and the European polity" ("uploading"), and an approach that tries to merge the two dimensions to create an interdependent pattern of action (Börzel & Panke, 2010, pp. 406-407). Before the hypothesis is developed from the theory of bottom-up Europeanization, it will be briefly explained why top-down Europeanization is irrelevant for this study.

<u>Top-down</u>

Top-down Europeanization assumes that not the regulations and guidelines as set by the EU affect the degree of harmonized implementation, but the willingness, flexibility and capacities of governments to do so. Theory suggests that EU legislation creates *adaptation pressure*[3]. If there is "some degree of 'misfit' or incompatibility between European-level processes, policies and institutions, on the one hand, and domestic-level processes, policies and institutions, on the other", the domestic level feels this kind of pressure (Börzel & Risse, 2003, pp. 4-7). Within this setting, in an earlier version of their text Börzel and Risse (2000, p. 5) point out that, obviously, adaptation pressure increases the higher the incompatibility of the domestic setting with the European provisions is. This also affects discretion, since high adaptation pressure requires large domestic changes and therefore leaves little discretion, whereas on the other hand Member States that already comply with EU requests face a smoother adaptation process with much more leeway (p. 10). The reluctance of Member States to implement desired procedures and institutional processes based on the incapacity of the domestic settings to adapt to the supranational conditions can be translated into discretion "conquered" *ex post* as described in the abstract that conceptualizes discretion. Looking at the implementation record of the relevant directives (see also "Case Selection and Sampling"), it becomes obvious however that the Member States did not conquer any leeway at all. Although the "*Lamfalussy* League Table" (European Commission, 2008a) indicates that with regard to some directives not all Member States took the required measures in time, continuative literature shows that the laggards all eventually complied with the legislation (European Commission, 2010, pp. 35-38), finalized by Poland implementing the MiFID (Polski Bank Przedsiebiorczosci, 2010; Szlachetka & Tarnowska, 2009). Accordingly, by implementing the legislation to the satisfaction of the Commission, the room to manoeuvre that the Member States applied was "granted" *ex ante*. This renders top-down Europeanization irrelevant for this study.

<u>Bottom-up</u>

The bottom-up approach of Europeanization deals with the shaping of EU legislation in the way the respective Member State wants it. However, the focus here shall not be upon a single Member State, but rather at all the 27 EU members altogether. One can formulate the relationship in a way that because Member States play a crucial role in the legislative process, legislation contains discretion or not because the Member States want it that way.

[3] Sometimes also referred to as *adaptational pressure*.

A rational and a normative view on this theory exist. Rational intergovernmentalism postulates that Member States are more willing to integrate and harmonize to the detriment of discretion the more national laws are already converging and hence EU law does not pose any painful innovations they might want to veto (Donnelly, 2011). In turn, this veto, especially by Member States with many votes, is feared in the Council, even if legislation would pass by a qualified majority. In addition, constructivist supranationalism also attributes this negotiation power to smaller Member States when they are able to convince other MS of their position because it resonated with the latters' norms and beliefs (Börzel & Panke, 2010, pp. 412-414; Lewis, 2005, pp. 953-964).

It becomes therefore obvious that EU legislation to a large extent depends on the normative consensus and the implementation cost considerations of the Member States. The more prior legislation converges and therefore Member States already agree upon positions on a specific topic, the more they are willing to integrate, yield powers to the EU and hence give up discretion. Put differently, discretion depends on the strength EU institutions already have in a specific issue area. Identifying the state and development of prior EU regulation as well as Member State's motivations with regard to this specific issue area is crucial in testing this hypothesis.

H1 EU Member States have more discretion in implementing legislation when prior legislation is diversified or undeveloped.

3.3.2 Principal-agent theory

Next to the legislative texts that govern EU legislation, the institutions of the EU play a crucial role in how long the leash for Member States is when it comes to implementation. Discretion for the Member States depends to a large extent on the *de jure* powers of the respective issue-area supervisor and how it executes these powers *de facto*. Considering these institutions and/or their powers as the result of EU legislation, we have to combine liberal intergovernmentalism with principal-agent theory to derive a hypothesis.

The idea behind the agency approach is that a fiduciary relationship is created between a principal and an agent. The agent shall act on the principal's behalf, is subject to the principal's control and, most important, the interests of the principal prevail over the interests of the agent (de Visscher, Maiscocq, & Varone, 2008, p. 26). In addition, as pointed out by Pollack (1997, pp. 108-109), to prevent non-fiduciary behavior by the agent that might be caused through non-converging interests, the principal can use *ex-ante* mechanisms like contract design and agent's screening and *ex-post* measures like sanctions and monitoring (de Visscher, Maiscocq, & Varone, 2008, p. 27). Applied to the European Union, the Member States can be considered the principals that delegate agency powers to the European institutions. It is obvious that therefore the Member States try to preserve their national autonomy as much as possible when creating new supranational authorities.

The establishment of the European Banking Authority – the successor institution of the Committee of European Banking Supervisors – in 2011 serves as an example. *Per se*, the tasks of the EBA are to establish an EU-wide framework of standards the national regulators shall follow. It is even allowed to interfere directly and skip a national regulator if the latter is not capable of dealing with the situation or breaches its obligations. However, EBA's enactments must not impose any obligations to the financial responsibilities of the Member States (Berschens, 2009).

Additionally, the mere composition yields power back to the Member States since the national regulators are in one way or the other bound to their respective ministries of finance. Finally, although *de jure* EBA can overrule national regulators, it is *de facto* quite unlikely that the authority puts aside some of its own members (Donnelly, 2011).

Still, the assumption that therefore the nation states create weak supranational institutions to prevent a loss of sovereignty is wrong. Rather, agency autonomy as created through the aforementioned *ex-post* and *ex-ante* mechanisms varies over time and across issue areas and institutions (Pollack, 1997, p. 129). Analysing which institutions matter, which powers they possess and how they can exercise them is therefore the core task to test this hypothesis.

H2 EU Member States have more discretion in implementing legislation when the crucial EU institutions are faithful agents on a short leash.

To answer the paper's research question what determines for the Member States in implementing the European Union's financial market regulation, these two hypotheses that are based upon theories on European integration and international relations therefore apply different possible explanations. They can be regarded as competing, in a way that one way of arguing renders the other redundant because of rejecting its assumptions. However, it is also possible that they build upon each other and work together, since none of them has to be an exclusive reason.

4. Methodology

4.1 Research Design

To find out what determines discretion in the national application of financial market regulation in the European Union, this paper will conduct a cross-sectional study. It picks out three "*Lamfalussy* directives", identifies the level of discretion that is attached to them and, according to the working hypotheses of this paper, looks for the explanations for the respective degrees of discretion. By undertaking this comparative case study, this research aims at yielding three coherent pictures that, through comparison, thoroughly display the size and the origin of Member State discretion in financial market regulation.

The study will proceed in the following way. Starting with the provision of a broader perspective, the general framework of the Financial Services Action Plan and the *Lamfalussy framework* will be explained. Afterwards, the three directives this paper is going to examine are discussed with regard to their purpose and their main features. Thirdly, it will be pointed out where in these directives room for discretion can be found and what it provides for. The study will continue with the testing of the hypotheses by pointing out where this discretion stems from. To conclude, the research question will be answered and an outlook will be given what the legislative changes and the 2011 reform of the institutional framework of EU financial market regulation contributed.

The timeframe of this study covers the period from 1999 up to 2010. The Financial Services Action Plan was established by a Commission Communication on May 11, 1999, and it was aimed that all its measures shall be transposed into national law by 2005 (Hartmann, Maddaloni, & Manganelli, 2003, p. 204). However, almost up to three years were added for the *Lamfalussy* directives that are subject to this paper (European Commission, 2008b). In addition, since this paper is also looking at the effects the respective legislation had, the span is extended up to the end of 2010 due to the fact that with the beginning of 2011 the institutional set-up for financial market regulation in the European Union was reformed.

The advantages of this research method are twofold, due to its in-depth approach to the subject under examination. First of all, case studies strongly contribute to theory-testing (Bennett, 2004, p. 29). In addition, this research design also is strong on internal validity since many variables and their relations toward each other are shed light on.

4.2 Case Selection and Sampling

This study wants to find out what determines discretion Member States of the European Union have in the sector of financial market regulation. This is done by examining legislation from this policy field. Since this paper focuses on the *capital market* as categorized by Klein (2000), the legislation here represents the financial services sector. Accordingly, the population from which the sample under study is drawn consists of the legislative documents based on the Financial Services Action Plan, since – as mentioned earlier – it was the starting point of comprehensive EU financial services regulation. The universal procedure for adopting legislation in this area was the *Lamfalussy framework*, so it is advisable to pick legislation that resulted from this procedure. Because initially this approach only applied to securities regulation, with the banking and insurances sectors following later, the legislative documents for examination will stem exclusively from securities regulation.

However, because in contrast to banking and insurances, securities regulation is by far the most supranationally developed policy field (Donnelly, 2011), for the purpose of this paper this will not heavily harm the possibility to draw inferences and generalizations for the whole financial market regulation. This limits the population to four directives (European Commission, 2008b), from which a purposive sample of three is drawn. The reason for that can be found in the text of Lee (2009) who identifies the three chosen directives as key elements of the FSAP (p. 3). In addition, whereas MiFID is rather embracing, the Prospectus Directive and the Transparency Directive deal with very specific policy issues, so this sample is ought to represent a balanced approach. This renders them as most useful and representative, a goal that purposive sampling strives for according to Babbie (2007, p. 184).

4.3. Data Collection and Analysis

The data collection for this study is mainly based on qualitative information. All in all, three variables have to be measured. The dependent variable here is *discretion*. As described, *discretion* stands for the room Member States are granted in implementing legislation. This room can occur by the provisions given in the legislative documents and via the possibility of adding extra measures – "gold-plating" – to the legislation when implementing it. We therefore identify this room to manoeuvre by examining the legislative texts and its implementation across the EU. This is done by examining scholarly articles and institutional reports from CESR (now ESMA) and the national authorities that inform about the implementation process. In addition, the EU publications as well as the national legislative documents are scanned to exactly define where discretionary space is given. To discuss discretion of the Member States as dependent on agent's autonomy for *H2*, a slightly different approach applies. The *Lamfalussy framework*, as will be explained later, consists of four levels. Level One directives that are drawn up by the regular co-decision procedure between the Commission, the Council and the Parliament set out a general framework that was later specified by the Level Two legislation and implemented at Level Three and Four (de Visscher, Maiscocq, & Varone, 2008, pp. 22-23). Since the crucial institutions that are deemed to be "agents" under *H2* mostly came into play after Level One, "discretion" here will be operationalized by looking only at the institutional reports and scholarly articles on implementation, since the ESC and CESR had nothing to do with *Lamfalussy* Level One legislation that will be used for the operationalization of *H1*.

The first test variable is *status of prior legislation*. Weak or non-existing prior legislation is assumed to yield more discretion. Therefore, we have to identify first the scope and reach of already existing EU powers in this area. In addition, if there has been no legislation, it is important what the Member States' preferences and opinions towards the issues were. If they shared the same preferences, theory suggests that they are willing to give up more discretion and yield powers to the EU. A document analysis of official government and sector-specific publications as well as newspaper and scholarly articles will serve as data source. If we find a directive to leave a lot of discretion although prior legislation was already highly developed and/or Member States' preferences on the issue converged, we can reject *H1*.

Next to this, the *autonomy of agents* will be analyzed as second test variable. *H2* assumes that discretion decreases the more autonomous agents can act. Agents are the institutions that are established through the respective legislation or serve as their crucial pieces. It is necessary to identify first which the relevant institutions on the EU level are at the issue area under consideration.

Afterwards, pointing out the ex-ante and ex-post control mechanisms the Member States established to oversee them will render their role as either strong or weak and hence show how much leeway they leave the Member States. Important to mention here is that the initial idea behind control mechanisms for agents is not to undermine their powers, but to prevent agency loss. The conditions here are tested only as a side effect of these mechanisms. The data for this is collected by examining the official documents of these institutions as well as scholarly articles and look for their rights and duties. If a directive shows a high degree of discretion, but the crucial authorities supervising its policy area are deemed to be rather autonomous agents, *H2* can be rejected.

4.4. Scientific and Social Relevance

The motivation behind this study lies in the turmoil at the global financial stage of the recent years. It focuses on the lower dimensions of the financial crisis by examining an issue that mainly concerns private investors and points out the reasons why the existing framework for financial market regulation was designed inappropriately to deal with the impact of the financial crisis (de Larosière, et al., 2009; Sève, 2010). This study further gives explanations why the first step of common European financial market regulation in the early 2000's was considered to need improvement by reforming the institutions established to manage this sector on the EU level and why its cornerstone, the Directive on Markets in Financial Instruments, will be revised only a decade later.

4.5. Limitations of this study

The limitations of this study can be found in the complexity of the environment it examines. The study explains shortcomings in securities regulation which is only one sector of financial market regulation, next to banking and insurance. Although the flaws within this sector contributed to today's problematic financial situation in Europe, this study cannot claim to sum up the remedies for the current crisis. In addition, since the system for EU financial market regulation was reformed in 2011 and it is yet too early to draw any valid results, especially because the crisis renders the whole sector rather unstable, this study infers results from earlier legislation. As another point it needs to be added that this study focuses only on discretion as being granted to the Member States. The short excerpt on top-down Europeanization and its main concept "adaptation pressure" assumes that this theoretical approach can be largely disregarded in this respect. However, a more thorough examination of why certain Member States implemented the specific directives with delay, and which domestic conditions influenced the way how the discretionary space the legislation left was used, would shed more light on how Member States can conquer discretion and therefore made generalizations and inferences more valid.

5. Analytical Framework II – Financial Market Regulation in the European Union

Before starting with the empirical results of this paper, an introduction will be given of the legislative and institutional set-up that serves as the basis of this study. Two main concepts are worth mentioning here: the Financial Services Action Plan and the *Lamfalussy framework*.

The FSAP was instigated at the Cardiff European Council in June 1998. To improve the performance of the Single European Market, it was concluded that the area of financial services needs additional efforts and that the Commission shall take action to evaluate and, if necessary, amend legislation (European Commission, 1999, pp. 3-4). As a result, the Financial Services Action plan featured three *strategic objectives* – a single EU market for wholesale financial services; open and secure retail markets; and state-of-the-art prudential rules and supervision (pp. 22-30) – and one *general objective* that dealt with wider conditions for an optimal single financial market (p. 31). Within this categorization, sub-points were attached to each objective that defined the single aspects more clearly and subsumed the particular measures proposed. These measures also received a certain level of priority in order to define what needs to be tackled immediately (Priority 1 Actions), where existing legislation needs to be amended (Priority 2 Actions) and what requires additional or new work and can also wait until the end of the Euro-transitional period (Priority 3 Actions) (p. 21). The FSAP also defined the respective actors who should be involved in the legislative processes for the particular objectives and attached an optimal timeframe. As shown in the table (Appendix A), in the end the FSAP proposed 43 legislative measures. Twenty of them were ranked with highest priority, which means that the implementation of almost half of them was urgently necessary to reach the goals to which purpose the FSAP was conceived. All in all, it was aimed at concluding all legislative processes at EU-level by mid-2004 and, with a following timeframe for the transposition into the domestic law of the Member States by 2005 (Hartmann, Maddaloni, & Manganelli, 2003, p. 204).

As a follow-up to the FSAP, on July 17, 2000, the Economic and Financial Affairs Council of the European Union appointed a Committee of Wise Men on the Regulation of European Securities Markets in order to find solutions how to improve the adaptation of European securities regulation and the effectiveness of their eventual transposition and implementation into domestic law (de Visscher, Maiscocq, & Varone, 2008, p. 20). The Committee identified "a plethora of interconnected factors and barriers" that hold up the development of a European securities market, naming *inter alia* an "inefficient regulatory system [and] inconsistent implementation of existing rules ". In addition, cultural, political and economic diversity among the Member States were also regarded as obstacles to a functioning European system (Lamfalussy, 2001, pp. 1288-1289). The resulting reform of the legislative processes regarding the areas addressed by the FSAP, proposed on February 15, 2001, was called the *Lamfalussy framework*, named after the chairman of the Committee of Wise Men, Alexandre Lamfalussy. The *Lamfalussy framework* strongly built upon the concept of comitology and featured four levels. At first, nothing differs from the regular proceedings under the co-decision procedure. At Level One, the Commission sends a proposal to the Parliament and the Council which adopt a legislative act. However, this contains only the framework principles of the subject matter.

At Level Two, the technical details how to implement the new legislative act, usually worked out by the Commission, are now defined by newly established committees: first, the Commission approaches the European Securities Committee, composed of Council members, a representative of the Commission and the ECB as an observer; second, the Committee of European Securities Regulators that consists of national regulators designated by their respective Member State advises the Commission. CESR forwards to the Commission a document that gives advice based on the consultation with market experts and consumers which is transposed into draft measures. In turn, the ESC then has to approve these measures in order to proceed. If the ESC does not state an approval, it is up to the cooperation of the Commission, the Council and the Parliament to find a solution. Level Three of the *Lamfalussy framework* marks the implementation phase. The responsibility for a sound application and the realization of truly European day-to-day practice lies with CESR by *inter alia* issuing administrative guidelines, joint interpretation recommendations and common standards in areas outside Community legislation. The fourth and last level of the *Lamfalussy framework* can be called the enforcement phase, where the Commission simply acts in its usual role as the executive of the EU in order to check whether the Member States act in accordance with the new laws. It is important to mention that whereas initially the *Lamfalussy framework* was only deemed necessary for the securities market regulation, in 2005 it was extended to the banking sector, insurances and occupational pensions and financial conglomerates (de Visscher, Maiscocq, & Varone, 2008, pp. 21-24). Similar to the newly established committees for the securities sector, the added areas should also get their respective Level-Two and Level-Three committees. The already existing Banking Advisory Committee and Insurance Committee were reformed to become part of Level Two; for Level Three, the Committee of European Banking Supervisors and the Committee of European Insurance and Occupational Pensions Supervisors were established to create a *Lamfalussy-framework* compatible institutional environment (Hartmann, Maddaloni, & Manganelli, 2003, p. 207).

6. Case Studies

6.1 Discretion in the Directives

The following abstract will introduce the three directives that will serve as unit of observation. After introducing the main features, it will be pointed out how much discretion they left for the Member States to implement them. It is important to mention that, whereas both MiFID and the Prospectus Directive are designed as "maximum harmonization" legislation (Casey & Lannoo, 2006, p. 2; Lee, 2009, p. 7), the Transparency Directive, as will be shown, leaves considerable room for "gold-plating'. "Maximum harmonization" with regard to an EU directive means that it is written in such detail that there is virtually no room for Member States to flexibly implement the legislation (Casey & Lannoo, 2006, p. 2). Accordingly, "gold-plating" – the term that refers to the practice of adding measures that exceed EU law (European Commission, 2012a) and therefore another way of having discretion with regard to implement EU directives – will only be of importance when dealing with the Transparency Directive.

6.1.1 MiFID

The first directive is the Directive 2004/39/EC on markets in financial instruments (MiFID). The reason why this directive will be part of the research is that it can be seen as the cornerstone of the FSAP and therefore of the financial market legal framework. Other FSAP directives were merely concerned with national regulatory frameworks for particular issues (e.g. prospectuses) and certain transparency requirements for the emitters. MiFID, on the other hand, brought forward investor protection and market efficiency and therefore promoted an integrated European securities market. MiFID featured several points that will be laid out in the following. It formulated detailed provisions in case a conflict of interest emerges between the investor and the investment firm. Furthermore, it also clarified on how to guarantee the objectivity and independence of financial analysts. Moreover, the *know-your-client* requirement and the *best-execution* provision were created to make sure that investment firms are able to identify the best products and services for a particular client and that they also execute this product or service with the lowest possible price and cost and the highest possible speed and likelihood of execution. Finally, by abolishing the concentration rule, MiFID aimed at increasing competition and market efficiency and included the multilateral trading facilities and systematic internalisers into their transparency requirements (Lee, 2009, pp. 13-19).

Due to the fact that MiFID is a "maximum harmonization" directive, it left little discretionary space for the Member States. However, because instead of dealing with one specific issue like the other two directives under consideration MiFID was rather embracing, some points and categories need to be mentioned were room to manoeuvre with regard to implementation was given. The most blatant one can be found in Article 3 that lays out which persons can be exempted from the directive. It provides for independent financial advisers to be potentially left out from the requirements if they exclusively operate in their home Member States. In addition, discretion can also be found looking into the paragraphs dealing with how to define best execution (Article 21). National legislators can choose whether they apply a narrow view and execute orders to the lowest price or a broad view that would also include other factors like speed. Moreover, if opting for the broader view, Member States will have the discretion in comparing whether, for instance, the benefits of a lower price outweigh the costs of lower speed.

The best execution provisions, if applied in the broader principle, also provide a means to circumvent the abolition of the concentration rule by strengthening existing exchange venues (Ferrarini, 2007, pp. 406-408; Ferrarini & Recine, 2006, pp. 265-266). Finally, article 22 leaves it to the Member States how to implement the display rule, giving them an option to constrain the business of systematic internalisers if they wish to do so.

6.1.2 Prospectus Directive

The so-called *Prospectus Directive*[4] was also part of the aftermath of the FSAP. In contrast to MiFID, it dealt with a more specific issue, namely the prospectus for financial securities. It tried to tackle the problem of a regulatory race to the bottom between the securities markets of the Member States which was caused by the fact that the stricter the requirements for a prospectus were, the less attractive the market was for the issuers. However, if every Member State would have watered down their prospectus restrictions to attract issuers, the transparency for investors would have decreased to a minimum. The Prospectus Directive defined what kind of information needs to be disclosed in the published document and also clarified that the language used should be easily understandable. Moreover, it created common standards by introducing a single passport system. Once the prospectus was approved by the respective authority in the home Member State, the issuer had to fulfill no further requirements and could offer its securities for trade in any other Member State of the EU. Accordingly, the directive also lowered the issuers' costs and made it easier for investors to diversify their portfolio (Lee, 2009, pp. 5-7).

Discretion for the Member States in implementing the Prospectus Directive was reduced to a minimum due to its maximum harmonization aspect (p. 7). The only room to manoeuvre worth mentioning is the provision in article 21 (2) that the Member States may allow their national competent authorities to delegate certain tasks, for instance to stock exchanges or national regulators of another Member State. However, as found by CESR (2007a, pp. 3-4), even if Member States included these provisions in their national application of the Prospectus Directive, the competent authorities virtually made no use of it. Taking a broader view, one can additionally identify another area where Member States have been left with considerable discretionary room. Article 25 stipulates that the methods for enforcement with regard to sanctions are completely left to the Member States, also with regard to civil or criminal liability (Lee, 2009, p. 7).

6.1.3 Transparency Directive

The third and last FSAP-directive that will be examined in this paper is the so-called *Transparency Directive*[5]. It established a new framework on reporting obligations that aimed to increase investor protection and the quality of the issuers' published information. The obligations formulated by the Transparency Directive concerned especially the disclosing activities of the emitters. All security issuers had to publish their financial reports. Based on the factor of how often financial statements are published, issuers were required to disclose additional information. Additionally, the directive also featured provisions on how to proceed when a significant stakeholder (minimum 5%) acquires or disposes shares (Lee, 2009, pp. 11-13).

[4] Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading

[5] Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market

The Transparency Directive leaves the Member State by far the most room for discretion in this comparison. Adding to the provisions that actually state that Member States may or may not apply certain measures, with the implementation of this directive a lot of “gold-plating” took place across the European Union.

The directive left discretionary space and room for gold-plating in its provisions with regard to several things: the deadline for publishing financial reports (Articles 4 and 5); the category of shares and issuers/firms to include (Article 8); the procedures on notification and disclosure of information in case acquisitions or disposals of holdings or major proportions of voting rights (Articles 9, 12 and 14); the disclosure requirements for different financial goods dealt on regulated markets (Articles 17-18); the rights and duties of the competent authorities (Articles 19 and 24); and penalties (Article 28).

The last point stands in line with the findings for the Prospectus Directive that also left discretionary space to the Member States to implement the proper consequences in case of breach. Additionally, within these issue areas Member States adopted a multitude of additional measures on top of what EU legislation required, reaching from setting even smaller thresholds for information disclosure than required by the directive to including actors, financial goods or documents the directive not addressed. Member States also exceeded information requirements with regard to content (ESMA, 2011a, pp. 8-23).

In sum, we can conclude that the Transparency Directive leaves a lot of discretionary space to implement for the Member States, whereas MiFID and the Prospectus Directive can be regarded as rather strict. Comparing MiFID and Prospectus, in absolute terms the Prospectus Directive sets even tighter standards. However, since the issues dealt with in MiFID are far more embracing than the very specific PD, these directives are relatively equal with regard to their level of discretion.

6.2 Hypothesis Testing

6.2.1 Bottom-up Europeanization

H1 EU Member States have more discretion in implementing legislation when prior legislation is diversified or undeveloped.

As pointed out by Lee (2009, p. 4), the 1999 Financial Services Action Plan was the first serious approach “to promote a fully integrated European capital market” by providing “the legal bedrock for EU financial markets’ integration through uniform rules”. Accordingly, we can assume that EU legislation in the field of financial market regulation was rather undeveloped or non-existent prior to MiFID, the Prospectus Directive and the Transparency Directive.

<u>MiFID</u>

As it can be found in its official name[6], the crucial piece that is important to find out about the status of MifID’s prior legislation is Council Directive 93/22/EEC on investment services in the securities field (ISD). ISD basically provides the basis for a harmonized approach to regulate investment firms.

[6] Directive 2004/39 EC of the European Parliament and of the Council on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC

It sets out *inter alia* the criteria for the authorization of investment firms; the requirements how to proceed with firms established in a third country; the rights and duties of home and host Member State with regard to branches and subsidiaries of Community investment firms; the provisions to keep up single-market standards by promoting mutual recognition and equal opportunities; certain rules for the Member States' authorities to supervise conduct of business; and procedures to be followed in case of breach (European Union, 2006).

However, ISD, as examined by Warren (1994), was "hardly harmonious" (p. 218) and left a lot of room for Member States to implement it. Fuzzy wording (home state authorization), provisions that left high degrees of discretion for the Member States (penalties), opaque standards (transparency) and requirements not going beyond the status of "common principles" to be interpreted by the Member State authorities (conduct of business) (pp. 193-217) prove that ISD, as compared to the *maximum harmonization* MiFID, allowed for "substantive variations from state to state" (p. 218). In a comparison to MiFID, Casey and Lannoo (2006) make this even clearer. They describe the change as a move "from a principles- to a rules-based approach" (p. 1) which makes the successor directive therefore much more detailed. It contains more specific regulatory prescriptions, which can be identified not only through the bare number of articles (169 to 32) but also via their respective lengths. In addition, MiFID not only reaches deeper into topics that were only slightly covered by ISD, like conduct-of-business rules, but also has a much broader scope than its predecessor (pp. 2-3).

<u>Prospectus Directive & Transparency Directive</u>

Both the Prospectus Directive and the Transparency Directive did not serve as a substitute to an outdated piece of legislation, but rather complemented Directive 2001/34/EC[7]. The main purpose of this directive was to consolidate the existing legislation on admission for securities to official stock exchanges and its accompanying information that was established mainly in the 1980's. It required the disclosure of certain information about the securities issued and the issuer in order to protect investors and ensures the coordination of requirements through mutual recognition. Thereby, it also dealt with transparency requirements with regard to the set-up of the issuing firms regarding financial reports and the allocation of holdings and voting rights (European Union, 2005).

The Prospectus Directive, however, was way more specific and hence fostered harmonization of requirements. First of all, in contrast to Directive 2001/34/EC that clearly expressed its "minimal" approach, Prospectus is a "maximum harmonization" directive, intended to leave no room and need for Member States to add extra measures. PD set out the details on the characteristics of the prospectus, the information it has to include, the procedure of approval, the rights and duties of the competent authorities and how the prospectus has to be made available to the supervisory authorities and the public. By doing so, PD also introduced a single passport that went beyond the principle of mutual recognition (European Union, 2011d).

The Transparency Directive picked out a part of Directive 2001/34/EC as well and created a legislative text that was more detailed. TD's provisions regarding periodic information (on financial reporting) or ongoing information (on reporting changes of holdings and/or vote allocations) had its foundation in the predecessor directive; however, by introducing new thresholds, timeframes and specific procedures, TD took these transparency requirements to a new level (European Union, 2011e).

[7] Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities

Compared to MiFID's predecessor, in a broader view the prior legislation of the Prospectus Directive and the Transparency Directive can therefore be considered more developed since, instead of being replaced, it only needed amendments. However, applying a narrower view, the specific field PD and TD covered – prospectuses and transparency requirements for issuers – was only part of Directive 2001/34/EC. Accordingly, taking these parts and drawing up complete new directives for them renders the step forward on the particular issue area more or less the same.

Member State Preferences

Having looked at the status of prior EU legislation, the next step is to identify the preferences of the Member States in the run-up to the directives. Taking a look upon the motivations behind the FSAP, the intentions across the EU largely pointed towards stronger integration and harmonization of at least the securities market. Not only was securities regulation across the EU relatively convergent (Donnelly, 2011), but gained recognition among the Member States in the end of the 1990's, resulting in their initiative to work out the Financial Services Action Plan together with the Commission (European Commission, 1999, pp. 3-4). Moreover, securities regulation was the first issue area that was legislated by the *Lamfalussy framework*, yielding core decision powers to the Commission and CESR (de Visscher, Maiscocq, & Varone, 2008, pp. 21-24). Although CESR still was set up of national authorities, Member States' move to give up core decision powers to a committee deemed to foster harmonization on a supranational level can be interpreted in favor of giving up discretion.

That being said, we can now check *H1* for correctness. Regarding MiFID and the Prospectus Directive that are deemed to leave little discretionary space for the Member States to implement legislation, *H2* is correct in assuming that converging policies and/or preferences lead Member States towards giving up discretion, even if prior legislation was poorly developed. On the other hand, the Transparency Directive seems to prove *H2* wrong since it leaves Member States with a lot of discretion to implement it although it was part of the FSAP which they supported so enthusiastically. However, by taking a closer look upon the topic, it is revealed that in addition to the weakly developed prior legislation, a crucial part of TD was a very controversial issue across the EU. Financial reporting standards heavily influence how companies' performance records look like, since they determine how to define a debt or a profit. With differing standards within the single market, this increases uncertainty for lenders and investors (Ball, 2005, p. 5). The main problem was that – next to France, Germany, the UK, the Netherlands and Ireland who already accepted IFRS of the International Accounting Standards Board (p. 3) – every single country had its own GAAP. Financial reporting standards were largely divergent (Whittington, 2005, p. 129), and the EU was not able to tackle this problem by negotiating a common standard but saw itself forced to circumvent negotiations and adopt the framework of the IASB (Regulation (EC) 1606/2002[8]). Even this posed several obstacles, for instance because IFRS need developed capital markets, a feature that especially the eastern European countries that just joined the EU were lacking (Carson & Street, 2004, p. 96). Other barriers were *inter alia* the tax-driven nature of the respective national accounting regime or specific incompatibilities of national vs. international standards (p. 98). Accordingly, whereas MiFID and PD could count on the harmonization enthusiasm of the Member States, TD lacked not only strong prior legislation but also the normative support.

[8] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards

We can therefore conclude that the assumptions of *H2* are correct. Discretion to implement legislation decreases when prior legislation is strong and/or existing policies or preferences are convergent. On the other hand, with poorly developed prior legislation and diversified policies and/or preferences among the Member States, legislation will leave more discretionary space.

6.2.2 Principal-agent theory

H2 EU Member States have more discretion in implementing legislation when the crucial EU institutions are faithful agents on a short leash.

Coming to the second hypothesis, we assume that Member State discretion in implementing legislation is dependent on the autonomy of agents. Agents here are the institutions taking a role as should-be supranational coordinator on the European level. However, if the Member States as their principals managed to keep them on a short leash, their true supranational powers are supposed to be limited. Accordingly, *H2* stipulates that discretion declines the more autonomous those agents can act.

Therefore, it is important to identify the crucial institutions in the legislative process of EU financial market regulation and how the various agent control mechanisms (Pollack, 1997, pp. 108-109) apply to them. Given that the three directives this paper deals with were created under the *Lamfalussy framework*, we can use this procedure as a thread to guide through this analysis, starting – as explained in the section on operationalization – with level two of the procedure.

As pointed out by de Visscher, Maiscocq and Varone (2008), the *Lamfalussy framework* was quite dense to get through identifying the relations of power delegation. However, for the purpose of this paper, only the connections of the Member States as principals delegating powers to other actors are important. Hereby, unlike de Visscher *et al*., there will be no distinction made between an agency and a trust relationship. It is simply about the delegation – the "outsourcing" – of power. Accordingly, we have to take a closer look upon the Commission and CESR. Whereas the Commission was given a direct mandate by the Member States, CESR only indirectly was delegated power by the EU countries since the Commission created it to help fulfilling its Member State mandate. Still, in the context of this research, CESR can be considered as an agent for the Member States as well since we want to examine the autonomy of crucial EU institutions other than the Member States/Council within the specific issue area. Although the ESC is deemed to be an agent of the Council as well, it only served "as a safety net for expressing vital national interests" and will therefore be captured when exercising the role of the Commission (pp. 26-32).

Ex ante, the Commissions scope included its role as part of the drafting as well as the enforcement of legislation. Obviously, it therefore possessed powerful legal instruments to perform its responsibilities: it is the sole initiator of EU legislation (Article 17 TEU), and as being the guardian of the Treaties, the Commission has not only the right, but the very task to initiate infringement procedures in front of the ECJ in case of breach. With regard to the procedures to be followed, the Commission is, as already stated, independent in the enforcement phase (still, the ECJ has the final say), but shares its role as being a legislator.

However, the agenda-setting power with regard to *Lamfalussy* stages two to four lied with the Commission, which gives it certain leverage if it is playing its cards right[9].

With regard to the *ex-post* control mechanisms that regulate the Commission's behavior, we begin with the monitoring mechanisms the EU Member States put in place. Borrowing from McCubbins and Schwartz (1984), Pollack (1997) identifies two procedures – police patrol and fire alarm – that work to oversee what the Commission is doing. "Police-patrol" oversight is the "active monitoring of […] the agent's behavior", whereas the fire alarm is ringing when a third party takes action seeking redress (p. 111). Applied to this example, comitology takes the role as police patrol, whereas the fire alarm bell to ring are various EU institutions in case any legal or natural person feels that the Commission is abusing its rights (pp. 114-116). The ESC as a regulatory committee was quite a powerful watchdog. It acted as co-legislator and can prevent the adoption of measures if it does not approve it by a qualified majority (p. 115; de Visscher, Maiscocq, & Varone, 2008, pp. 22-23). However, since the director of the DG Internal Market chaired the committee, the Commission had some degree of control within the ESC (p. 29). On the other hand, the Parliament, the Court of Auditors and the ECJ can be considered "fire-alarm" institutions. The EP approves (and has the right to dismiss, although as a whole) the Commission, although this measure is rather costly. The Court of Auditors has a crucial monitoring function over the budget. Lastly, the ECJ can be considered the most powerful "fire-alarm" institution since any natural or legal person can bring a case in front of the Court which then can declare Commission acts as void or rule that the Commission has failed "to act on its responsibilities under the treaties" (Pollack, 1997, p. 116).

Regarding budgetary control of the Commission, the means the Member States possess are powerful, but costly. The EU budget is very specific, with "financial services" being an own category within the budget of the DG Internal Market (European Commission, 2012b). Accordingly, the money granted to the Commission is quite closely bound to its purpose, and transferring money from one DG to another is rather unlikely. Moreover, whereas the Commission drafts the annual budget according to the calculations of the recipients, it is the Council and the Parliament who then decide over the final shape of the financial plan (European Commission, 2012c). They also have a say in allocating certain flexibility instruments to cover expenses that exceed the intended maximum for a category (European Union, 2004). The reason why these powerful measures are however costly are explained by Pollack (1997, p. 117) when he refers to Moe (1987), stating that cutting "the agency's budget as punishment, […] it is simultaneously denying the agency the very resources it needs to comply with the […] wishes". Especially with regard to such a crucial institution like the Commission, cutting the budget is therefore an unlikely sanction.

Another possible measure to clip an agent's wings is to control its personnel via appointments. However, Article 17 TEU that defines how the Commission is assembled says that the Member States only have a limited say in shaping the face of the Commission. The European Council proposes a candidate for the position of the President of the Commission who however needs approval by the EP. Secondly, every Commissioner is proposed by the Council and the Commission President together. However, the whole Commission then needs approval by the EP. The Directorates General and the lower administrative levels are appointed then by the Commission.

[9] Pollack (1997) refers to Victoria Gerus' "Comitology within the European Community's policy-making process: A mechanism of political control in the intern-institutional relations of the Council of Ministers and the Commission" from 1991, stating that agents may be able to anticipate their principal's preferences and hence circumvent sanctions by acting accordingly.

Changing the face of a college in place is even more out of reach for the Member States since commissioners need to resign only if asked to do so by the President. Accordingly, the power of the Member States to control the Commission via the appointment of their personnel is very limited. The EP serves as watchdog and has the final say in approving the college the Commissioners. However, since this mechanism is supposed to be an *ex-post* measure, the focus should lie upon the point when the Commission is working and the Member States try to sanction shirking. And here, the leash is even longer. If a new Commissioner needs to be appointed, the President has to confirm the choice as well as the EP. And secondly, on the lower levels, the Commission alone appoints civil servants like Director Generals. Even if one now assumes that these high-level civil servants might have made use of a certain degree of benevolence from their domestic administrations to acquire such a position, in that case the Commission certainly will not approve a change in staff that is a means to sanction its behavior.

Finally, the last mechanism according to Pollack (1997) to sanction agency shirking is new legislation, either in the form of overriding the agent or to revise its mandate and the procedures that form the basis of it. This however is very difficult since the Commission is usually the sole initiator of EU legislation. If it deems legislation as a sanction against itself, it may simply not open a legislative procedure. There might be some room for that when the EP and the Member States have common preferences, since they are allowed to alter a proposal once the procedure is opened. However, it is quite unlikely that a harmless proposal turns into a hostile legislative act with the Commission just being a bystander.

To conclude, the Commission can be viewed as an agent on a rather long leash. *Ex ante*, it is given a strong role not only in enforcement, but also in legislating within the *Lamfalussy framework*. *Ex post*, only the monitoring mechanisms the Member States can use to control agency shirking can be regarded as powerful, since the diverse options to sanction the Commission exist only *de jure*; *de facto,* budgetary control, control over appointments and overriding legislation are ineffective and therefore not applicable.

Next to the Commission, the Member States also delegated powers to the Committee of European Securities Regulators regarding the *Lamfalussy framework* legislation process. *Ex ante*, Commission Decision 2001/527/EC defined the conditions determining the scope and procedures of CESR. It was set up as an independent advisory body and had a crucial role in assisting the Commission implementing the FSAP with regard to the technical details of securities legislation. In addition, CESR should facilitate and enhance the cooperation between the national supervisory authorities through guidelines, recommendations and “common standards in areas not covered by Community legislation” (de Visscher, Maiscocq, & Varone, 2008, p. 23). With regard to the procedures to be followed, CESR was allowed to act on its own initiative or when the Commission sets out a mandate. In case of the latter, a time limit may be set out to provide the requested advice. The Committee was required to consult market participants, consumers and end-users before transmitting its opinion to the Commission. In addition to the requirement of frequent information *vis-à-vis* the Commission, the Commission was enabled to be present at CESR meetings and to participate in the debates. Decisions may be taken on the basis of QMV as laid down in the Treaty, however, consensus is very much preferred. Considering the legal instruments that are at the Committee’s disposal, we have to refer to Article Three of the Commission decision, stating that the “Committee shall fulfil the tasks assigned to it […] by issuing non-binding guidelines, recommendations and standards”.

However, although this seems quite toothless at first sight, CESR's purpose was to fill the gap of expertise in such a highly detailed policy field like securities legislation. Therefore, there is a good chance that the advice given by CESR was applied by the Commission when drafting the implementing measures on *Lamfalussy* level two. The same holds true for level three, when CESR worked on the domestic level in cooperation with the national legislators.

The *ex-post* mechanisms for the Member States to monitor and sanction the behavior of CESR will be displayed in the following. Starting with the former, again the terminology of "police patrols" and "fire alarms" by McCubbins and Schwartz (1984) will help to identify monitoring mechanisms. Firstly, the ESC can be considered as a police patrol overviewing the actions taken by CESR. Although it was established to "watch" the Commission and not CESR, the capacity to reject the draft implementing measures the Commission drew up on the advice of CESR gave the ESC a somewhat indirect "police patrol" function. Two additional mechanisms of the same nature can be found in the Commission Decision 2001/527/EC which required the Committee to annually submit market assessments to the Commission and to draw up annual work plans, since this shall also be delivered to the Council. Similar to the case explained for the Commission, the fire alarm mechanisms in place were the Court of Auditors reviewing the spending and the European Court of Justice.

Looking at the sanctions the Council had at its disposal to react on CESR shirking, again we start with budgetary control. Today, CESR's successor ESMA is funded by a mixture from the EU budget (40%) and contributions of its members, the national competent authorities (60%) (ESMA, 2011b). Assuming that this more or less fifty-fifty division applied to CESR as well, half of CESR's budget could be controlled by the Member States. The reason for that is the same as applied with the Commission: CESR made up an own category within the budget (European Commission, 2012b), so when approving the annual financial framework, EP and Council were aware of the means CESR was supposed to get. Therefore, this half of the financial means was dependent on the agreement of the Member States. On the other hand, the other 50% of CESR's budget came from contributions of the competent national authorities which fund themselves via fees and penalties paid from the national actors they regulate. This side of the budget was therefore not under the control of the MS.

Coming to the question whether or not the Member States could sanction CESR by executing control over its appointments, Article 7 of Commission Decision 2001/527/EC is quite clear: "The Committee shall be composed of high-level representatives from the national public authorities competent in the field of securities […]. Each Member State shall designate a high-level representative from its competent authority to participate in the meetings of the Committee." This high-level representative was the head of the respective national competent authority in securities regulation (CESR, 2007b), which are closely bound to the respective national ministries. Although it becomes therefore obvious that the Member States do not directly appointed CESR members, they had at least limited influence on its personnel. However, due to the power of office, it seems quite unlikely that the head of a competent national authority is replaced by its government just to sanction CESR.

Lastly, the possibility for the Member States to sanction CESR with additional legislation needs to be checked. Starting with simply overruling CESR, first it needs to be borne in mind that CESR did not legislate; it only advised the Commission which then adopts legislation in accordance with the ESC. Therefore, because the Commission established CESR as an assistant in this policy field, the only possibility for the Member States to overrule CESR with simple new legislation was when MS preferences were similar to the Commission and both wanted to ignore CESR's advice.

Based on the described situation, this is rather unlikely. On the other hand, revising CESR's mandate would have basically required the abolition or fundamental change of the *Lamfalussy framework*. Again, since this also needed the Commission's approval, the probability that this is going to happen was quite low.

For CESR, we can conclude that as with the Commission the leash was rather long. *Ex ante*, CESR played an important role in the legislative process since the *Lamfalussy framework* largely built upon its expertise, even though it had not the power to issue legally binding measures. *Ex post*, monitoring should have worked quite well via the ESC; however, the sanctioning mechanisms that could be used were at best limited.

All in all, however, the Commission and CESR must be regarded as being under quite effective control. Applying the metaphor of both institutions as being dogs on a leash, although the leash might be long, the Member States were able to look after their pet over a large distance via the ESC. Hence, assuming that the ESC did its work right, agent's autonomy under the *Lamfalussy framework* levels two to four was very restricted. That means that we have to reject *H2* for MiFID and the Prospectus Directive since, in contrast to the assumption that agents on a short leash yield more discretionary space, both the directives do not provide much room to manoeuvre for the Member States. Only the Transparency Directive, leaving much leeway for the Member States to implement it, confirms the hypothesis.

7. The Reform

This study has found out that the main determinant of Member State discretion in EU financial market regulation are the Member States themselves. If they deem it desirable to grant lots of autonomy to a supranational regulator/supervisor, legislation is rather strict and leaves little room for manoeuvre. On the other hand, where their interests and/or preferred approaches diverge, legislation is created so as to leave room to interpret it differently or take the necessary extra measures in order to make it nationally applicable. However, the conditions examined here have been reformed recently. In order to have an impact on what this study found, these changes should therefore either increase the autonomy of the Commission and CESR *vis-à-vis* the Member States during the legislative process or contribute to the convergence of Member State interests regarding financial market regulation.

With regard to this, we will now take a look at changes that occured in the sector of financial market regulation and evaluate whether or not they tackle the shortcomings identified by this study. This will be done by putting the focus on both legislative as well as institutional alterations. The Lisbon Treaty introduced changes to the *Lamfalussy framework*, whereas the 2011 reform of the financial market regulatory set-up in the EU *inter alia* changed the role of CESR.

Starting with the changes brought by the Lisbon Treaty 2009, we will first look upon novelties in the *Lamfalussy framework* and the comitology. The initial approach had only one role in mind for the ESC. Once the primary legislation specified that power to adopt secondary legislation will be delegated to the Commission, the ESC was supposed to act as an advisory committee on level one and as a regulatory committee on level two (Committee of Wise Men, 2001, p. 29; de Visscher, Maiscocq, & Varone, 2008, p. 22), based on the comitology Council Decision 1999/468/EC. However, the Lisbon Treaty 2009 altered this set-up. Primary legislation, if it delegates power to adopt secondary legislation to the Commission, can either refer to Article 290 or 291 TFEU. Under Article 290, the primary legislation delegates to the Commission alone the power “to adopt non-legislative acts of general application to supplement or amend certain non-essential elements of the legislative act”. This delegation can be prevented by the Council or the EP and also leaves out regulatory committees. Only under Article 291, the role of any committee to assist the Commission in adopting secondary legislation may exceed the role of an advisor. The Commission is also allowed to adopt legislative acts. Additionally, another piece of legislation is worth to be mentioned, although it does not alter the procedures with regard to this special case. Regulation (EU) 182/2011 reformed the comitology procedure. Leaving only the advisory procedure in place, the regulation replaced the remaining procedures from Council Decision 1999/468/EC with the so-called examination procedure (Financial Services Authority, 2012). Besides acting as an “examination” committee instead of a regulatory committee, however, the role of the ESC stays the same. Also the procedure on how secondary legislation can be adopted or rejected does not change.

Analysing the changes to the *Lamfalussy framework*, we have to conclude that *per se* the Commission is given a little more power. Under Article 290 TFEU, it is allowed to act alone when adopting secondary acts. Those acts are, however, only of non-legislative nature. In addition, before the Commission is allowed to act under Article 290 TFEU, this procedure was defined by the Council through the ordinary legislative procedure. It is therefore autonomy allowed by the Council, so it should not be interpreted as move toward more independence of the Commission.

However, it might be possible for the Commission to use this role to push MS interests towards more supranational power, for instance by making stricter supranational legislation desirable for a better working single market. If the Commission is able to do so, it can exploit the MS preferences to deprive them of their discretion.

Next to the legislative changes just described, with the beginning of 2011 the institutional framework for EU financial market regulation was reformed as well, based on the desire of the Commission to respond to the ongoing financial crisis and the suggestions of the *De Larosière* report. As a result, the role of the level-three committees of the *Lamfalussy framework* was changed. In the following, it will be described what has changed for CESR and what this means in relation to the findings of this study.

It needs to be mentioned first that with January 01, 2011, CESR's name changed into ESMA. Basically, CESR had the institutional form of a committee and provided technical advice in the legislative process, gathered information on market developments and suggested industry standards. The powers of ESMA build upon the tasks, rights and responsibilities of its predecessor; however, its scope is significantly wider and deeper (Fischer-Appelt, 2011, p. 22). ESMA exceeds the status of a committee by possessing legal personality as an EU agency and its founding regulation contains an independence guarantee (Article 5)[10]. By having the mandate to develop draft legislation, it can be regarded as a "quasi rule-maker". This is supplemented by the role ESMA may take under the aforementioned delegations of Articles 290/291 TFEU. When exercising its role in the enforcement process of legislation, it is allowed to adopt binding decisions addressed directly at financial institutions in breach of EU law. Moreover, in emergency situations, it may also adopt those decisions *vis-à-vis* the competent authorities of the Member States or prohibit certain financial products and services. Another important point can be found in the procedures framing ESMA's capacity to act. In contrast to the consensus-driven CESR, ESMA's board of supervisors is able to decide by simple majority, which speeds up the decision-making process and adds a considerable bite since this represents a move toward a true supranational supervisor instead of the accumulation of 27 (EU perspective) national interests. ESMA is also deemed to have a more secure funding basis than CESR (Fischer-Appelt, 2011, pp. 21-24; Moloney, 2011, pp. 529-533).

Concluding on the reforms undertaken regarding the supervisory institutional framework, ESMA clearly has more powers than its predecessor CESR. However, with regard to the focus of this study, the question is whether it is also more independent from the Member States. And here, the results are not as clear. The autonomy ESMA might enjoy is still delegated to it under Article 290 or 291 TFEU by the Member States. In addition, the power to act in an emergency situation depends on whether or not the Council considers the situation to be an emergency. Therefore, viewed from this angle, the default condition is still the same: Member States are able to exert considerable control over ESMA. However, this statement needs a slight qualification. Moloney (2011) points out that due to market developments and circumstances ESMA might incrementally gain additional powers. Assuming that the Member States strongly rely on the guidance and proposals of ESMA, it might be able to become a "de facto rule maker" (p. 532) and manipulate Member States' interests toward thicker supranational powers.

[10] Regulation (EU) No 1095/2010 of the European Parliament and of the Council establishing a European Supervisory Authority (European Securities and Markets Authority)

All in all, we therefore have to say that, based on the findings that Member State discretion in implementing EU financial market regulation is mainly determined by the Member States themselves, the changes and reforms of the EU FMR framework do not immediately contribute to a shift of power towards a supranational regulator. However, especially with regard to the establishment of ESMA, prerequisites have been put in place that might, under certain circumstances, enable the EU institutions to steer Member States' interests into the direction of yielding discretion.

8. Conclusion

This study explained what determines discretion for the Member States in financial market regulation in the European Union.

Since the *De Larosière* report identified an improperly working framework for EU FMR as one of the reasons why the current financial crisis could have such a large impact on all sorts of market participants, this paper was interested in finding out where the loopholes in legislation come from that leave Member States room to implement financial market legislation that the framework that was established only a decade ago already needs revision.

In a cross-sectional comparative case study, three directives have been examined with regard to how much room they left for differing national application. The directives constitute key pieces of financial services legislation, based on the intention of this paper to focus on the capital market according to Klein (2000). Along with the findings of how much discretion is left with each directive, this paper applied two theoretical approaches that are based on the liberal intergovernmentalist idea of influential Member States and limited EU powers. Each has a different explanation on what determines Member State discretion in FMR. Bottom-up Europeanization assumes that the degree of discretion within the legislation is determined by the interests of the Member States: if they consider it to be a good thing to yield a lot of power to a supranational regulator – based upon the fact that high coordination and strict cooperation is required or simply because national practices already converge anyway –, then legislation contains little space to move. On the other hand, principal-agent theory stipulates that discretion is determined via the autonomy of agents in the respective issue-area. The more autonomous the agent – in this case, the supranational institution the Member States yield power to –, the less Member States have room to manoeuvre.

The study found that of the three directives that have been examined, two left little discretion for implementation whereas one contained considerable room to move for the Member States, especially with regard to "gold-plating", the adding of extra measures on top of the legislative requirements. After a thorough document analysis of scholarly and newspaper articles as well as sector-specific publications and secondary legislation, the conclusions of this paper have been that the sources for the differing levels of discretion can be found in the explanations given by bottom-up Europeanization. MiFID and the Prospectus Directive left little room for Member States to interpret them because across the European Union there was a normative consensus that in these specific issue areas legislation should be maximally harmonized. On the other hand, differing requirements with regard to the transparency of operations of financial institutions led to a Transparency Directive that was implemented across the EU along with an abundance of extra measures.

For principal-agent theory, however, according to the findings of this paper the hypothesis must be rejected. Although the Member States are able to keep the relevant agents – the Commission and CESR – under quite effective control, only the Transparency Directive left considerable discretionary space. Still, this confirms the findings mentioned before: for MiFID and the Prospectus Directive, the Member States obviously wanted to yield discretion to a supranational authority; hence, both the directives are termed "maximum harmonization" legislation.

As a last step, this study also pointed out changes made to the legislative and institutional framework of EU FMR and connected them to the aforementioned results. Although especially the 2011 institutional reform increased the power of the relevant supervisory authority (ESMA) in the securities sector, with regard to the problems pointed out in this paper not much has changed. The autonomy of the supranational institutions is still dependent on the benevolence of the Member States. However, once they have given it green light, it might be able to use its role to push MS interests into a direction where they find themselves with few other or worse options than to demand legislation that puts the supranational regulators behind the steering wheel.

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10. Appendix

Table 2: *The Financial Services Action Plan*

			Sub-points	**Number of measures proposed**
<u>Objectives</u>	**Specific**	*a single EU market for wholesale financial services*	raising capital on an EU wide basis	19 PR* 1: ten PR 2: five PR 3: four
			establishing a common legal framework for integrated securities and derivatives markets	
			towards a single set of financial statements for listed companies	
			containing systemic risk in securities settlement	
			towards a secure and transparent environment for cross-border restructuring	
			a Single Market which works for investors	
		open and secure retail markets	Elimination of price differentials across the EU	9 PR 1: three PR 2: five PR 3: one
			consumer protection	
		state-of-the-art prudential rules and supervision	Elimination of gaps in the EU supervisory framework (new capital adequacy regimes)	10 PR 1: five PR 2: three PR 3: two
			Money laundering and e-money regulations	
			winding-up provisions for financial institutions	
			Regulation of financial conglomerates	
	General	*wider conditions for an optimal single financial market*	Tax issues, notably tax harmonization	5 PR 1: two PR 2: one PR 3: two

*(PR = Priority Ranking)