THE ROLE AND FUNCTIONING OF MUTUAL RECOGNITION IN THE EUROPEAN MARKET OF FINANCIAL SERVICES

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Abstract In Europe part of the rule-making and the whole enforcement of financial services regulation still take place at national level. For this reason, mutual recognition of national financial laws remains an element of central importance in the creation and regulation of a European market in this field. This article seeks to contribute to the analysis of such legal instrument, as several aspects of its functioning often appear unclear. The article starts by analysing the principle of mutual recognition as developed by the European Court of Justice. An important distinction is drawn between such judicially created principle and the principle of mutual recognition applied by the EC legislator. The article then looks at the question of why mutual recognition has not succeeded as a regulatory mechanism of financial services market integration, and at the role of mutual recognition after the introduction of the so-called 'Lamfalussy' law-making process to the financial services sector.

I. INTRODUCTION

One of the most important legal instruments in international and transnational relations is mutual recognition. Its basic function is to grant effect to foreign legal rules or acts occurring in the territory of another State. It is an established principle in both public and private international law; for example, in public international law, there is a duty to recognize determinations of foreign nationality so long as these comply with international standards. Similarly, conflict-of-laws legislation generally envisages the 'recognition' by a civil court of marriages celebrated abroad or of a contract governed by foreign legal rules. Mutual recognition is used in the commercial sphere to overcome any hindrances to the international movement of natural and juridical persons, goods and services that may be posed by the coexistence of multiple national jurisdictions.[1]

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[1] In the WTO law context, for example, the General Agreement on Trade in Services (GATS) provides for mutual recognition among WTO Member States of authorization, licensing, or certification of services suppliers (Art VII).

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In European law, mutual recognition has an especially crucial role. The EC Treaty itself expressly makes use of the principle in two specific areas, Articles 47 and 293.[2] Mutual recognition is prominent in the law of the European internal market following two significant developments. In the 1979 *Cassis de Dijon* case,[3] the European Court of Justice (the 'Court' or 'ECJ') introduced the 'judicial' principle of mutual recognition (see below Section II). This was followed by the European Commission's 1985 White Paper on completing the internal market,[4] which set out the foundations for the 'legislative' principle of mutual recognition (see below Section IV). In both instances mutual recognition was applied as one of the key elements of the strategy adopted to create the internal market.[5]

This article examines mutual recognition in the context of EC law, especially in the field of financial services. The first part of the article, Sections II–IV, analyses the obligation of mutual recognition as developed by the European Court of Justice as it applies to the freedom of services provided by the EC Treaty. Here two distinctions will be drawn: the first between the judicial and the legislative principle of mutual recognition, the second between the judicial principle of mutual recognition and the principle of functional equivalence. The second part of the article (Section V) looks at the question of why mutual recognition has not succeeded as a regulatory mechanism of financial services market integration, and at the role of mutual recognition after the

[2] Art 47 EC provides for directives to be issued for the 'mutual recognition of diplomas, certificates and other evidence of formal qualifications' to facilitate the freedom of establishment for the self-employed. Art 293 EC states that Member States shall enter into negotiations with one another to ensure 'the mutual recognition of companies and firms'. Mutual recognition in the EU has been recently extended to criminal law matters. See S Peers, 'Mutual Recognition and Criminal Law in the European Union: Has the Council Got it Wrong?' (2004) 41 CMLR 5–36.

[3] Case 120/78 *Cassis de Dijon* [1979] ECR I-64.

[4] 'Completing the Internal Market', White Paper from the Commission to the European Council, COM(85) 310 final.

[5] The 'Cassis de Dijon' doctrine has spread from goods to the other fundamental freedoms, including the freedom of services, while the Commission's proposal in the White Paper was sanctioned in the 1987 Single European Act and has become the new approach of the subsequent liberalization directives in the financial services sector, substantially based on the principle of mutual recognition and on essential harmonization. This approach was new when compared with the original approach to harmonization aimed at introducing detailed harmonized rules so that the standards applicable in each Member State would be equivalent. In the White Paper the Commission noted that 'experience has shown that the alternative of relying on a strategy based totally on harmonization would be over-regulatory, would take a long time to implement, would be inflexible and could stifle innovation' (para 64).

The 'Cassis de Dijon' doctrine has also expanded geographically, outside the borders of the European Community. Through the conclusion of the EEA (European Economic Area) Agreement and the EC–Turkey customs union, the principle of mutual recognition has, with some variation, now been extended to goods coming from Norway, Iceland and Liechtenstein (as EEA members) and Turkey. In order to implement this principle the European Commission has insisted that EU Member States insert a 'mutual recognition clause' in their technical legislation. The actual implementation of such clauses might have the effect of giving a preference to goods originating from the above-mentioned countries compared to goods of other non-EU origin. L Bartels, 'The Legality of the EC Mutual Recognition Clause Under WTO Law' (2005) 8 J Int Econ L 691–720, examines whether this poses any problems under WTO law.

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introduction of the new European model of law-making (the 'Lamfalussy process' or 'Lamfalussy reform') to the financial services sector.

II. THE FREE MOVEMENT OF SERVICES AND THE 'JUDICIAL' PRINCIPLE OF MUTUAL RECOGNITION

Article 49 et seq of the EC Treaty (EC) recognize the freedom to provide and to receive services within the European Community. Probably the most difficult type of legal restrictions to remove stems from the existence, within the EC marketplace, of multiple and different sets of national rules which are potentially applicable to the same activity. A service-provider may be subject to different or even contradictory regulations. A regulation imposed by the home State (where the service-provider is established) may conflict with a regulation of the host State (the foreign jurisdiction in which activities are undertaken). This is often referred to as 'double regulation' or 'dual burden'.

To remove this difficulty, the ECJ has interpreted the freedom to provide services such that Member States are under the obligation of mutual recognition. According to the Court's interpretation,[6] Article 49 EC does not only lay down a non-discrimination rule, but also entails additional obligations, including the duty of mutual recognition.[7]

In the field of services, the mutual-recognition obligation requires that the host State may not prohibit, impede or make less attractive an export from a provider already established in another Member State in which he lawfully supplies a service similar to the one he intends to export.

According to the original plan, obstacles deriving from the existence of multiple and different sets of national law rules applicable to the same activity, should have been removed by the Community via a gradual and detailed harmonization of Member States' laws. As the legislative efforts failed, the Court intervened by applying the principle of mutual recognition, first in the field of goods (in the landmark *Cassis de Dijon* judgment) and then in respect

[6] Case 76/90 *Saeger v Dennemeyer* [1991] ECR I-4221.

[7] In the Court's interpretation, the non-discrimination rule exclusively prohibits unequal treatment, de jure and de facto, of providers resulting from the law of a single national legal system. That ban does not remove restrictions deriving from differences between national regulations. See M Gardeñes Santiago, *La aplicación de la regla de reconocimento mutuo y su incidencia en el comercio de mercancías y servicios en el ámbito comunitario e internacional* (Eurolex, Madrid, 1999) 57; M Fallon, 'Les conflits de lois et de juridictions dans un espace économique intégré. L'expérience de la Communauté européenne' (1995) 253 Recueil des Cours de l'Académie de droit international de la Haye 13, 119–40, esp 123. The Court found indistinctly applicable measures to be unlawful in so far as they are imposed on providers that are already subject to the home State regulation. These measures create an additional regulatory cost for foreign providers and put them at a disadvantage compared with domestic providers. In carrying out such an assessment the Court has never used the concept of discrimination. See, eg, Case C-272/94 *Guiot* [1996] ECR I-1905, para 14.

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of the other fundamental freedoms.[8] In the field of services, the mutual recognition was first applied in *Saeger*.[9]

In the Court's interpretation, Article 49 EC

> requires not only the elimination of all discrimination against a person providing services on the ground of his nationality but also the abolition of any restriction, even if it applies without distinction to national providers of services and to those of other Member States, when it is liable to prohibit or otherwise impede the activities of a provider of services established in another Member State where he lawfully provides similar services.[10]

The obligation of mutual recognition applies under two conditions; firstly, the provider must be already established in another Member State, and secondly, the provider must lawfully provide in the home State a service similar to the one he intends to supply in the host State. When both conditions are met, mutual recognition creates a relative presumption that any regulatory and supervisory activities exercised with respect to the foreign provider are incompatible with the EC Treaty. A measure imposed by the host State on a foreign provider is very likely to have the effect of prohibiting, impeding or making less attractive the provider's cross-border activities. Therefore, as a general rule, any requirement imposed by the host State on a foreign provider will prima facie breach Article 49 EC. The host State can rebut the presumption by proving that the measure is justified. Restrictions on the free movement of services are exceptionally justified by the EC Treaty (Article 46 para 1, Article 55) on grounds of public policy, public security or public health. Other exceptions have been admitted by the ECJ (the 'general good exceptions'). Restrictions falling either within the first or the second category must also be in line with the proportionality principle to be justified. The proportionality principle entails three tests: the suitability test, the necessity test and the proportionality *stricto sensu* test.

The aim of the mutual recognition principle is to prevent the host State from applying its rules to a service that is already subject to the rules of another jurisdiction. To guarantee the free movement of services the provider must be able to remain subject to a single set of national rules, even though he operates in several jurisdictions.

The principle of mutual recognition creates a positive and a negative obligation for the host State. As regards the positive obligation, the host State must open itself up to foreign legal rules and acts. It must *recognize* such rules and acts as being capable of producing effects within the host legal system, or being capable of constituting the precondition for the production of the effects that, in the host State, follow from its own rules and acts. For the negative

[8] P Craig and G De Búrca, *EU Law* (2nd edn, OUP, Oxford, 1998) 582–3.

[9] Case 76/90 *Saeger v Dennemeyer* [1991] ECR I-4221, para 12.

[10] ibid; Case C-43/93 *Vander Elst* [1994] ECR I-3803, para 14; Case C-272/94 *Guiot* [1996] ECR I-1905, para 10; Joined Cases C-369/96 and C-376/96 *Arblade et al* [1999] ECR I-8453, para 33.

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obligation, the host State must exercise self-restraint: it may not restrict the activities of a foreign provider by imposing legal requirements or administrative controls. The host State may derogate from such prohibition only on an exceptional basis under certain conditions.

III. THREE QUALIFICATIONS ABOUT THE 'JUDICIAL' PRINCIPLE OF MUTUAL RECOGNITION

A. Mutual Recognition and Functional Equivalence

The freedom to provide services consists of a rule ('restrictions are prohibited') and an exception to that rule ('some restrictions are allowed'). The principle of mutual recognition falls under the rule, while a measure violating the obligation of mutual recognition constitutes a restriction. Such a measure is thus contrary to EC law unless it falls under the exception. Hence, the fundamental freedom entails a two-stage analysis: the first stage is aimed at determining whether a measure restricts cross-border trade (for example, whether it is discriminatory, or violates the principle of mutual recognition, or restricts the access to a foreign market). If the answer is positive, the analysis proceeds to the second stage, where it is ascertained if the restriction may be justified.

This makes it easier to explain the relationship between the concept of 'mutual recognition' and the concept of 'functional equivalence' between national laws. Different readings of this relationship correspond to different interpretations of the mutual recognition principle.

In academic literature, mutual recognition and functional equivalence are often viewed as forming a single concept, and as being part of the proportionality principle. It is argued that the equivalence between host State law and home State law is a necessary condition for the mutual recognition principle to apply.[11] It is also argued that equivalence is the essential component of mutual recognition, and it is thus preferable to use the expression 'principle of equivalence' rather than 'principle of mutual recognition'.[12] In the same vein, Weiler has stated that the principle that originated from *Cassis de Dijon* should not be labelled with the misleading expression 'principle of mutual recognition', but should be referred to with the more correct name of 'functional parallelism'.[13] Moreover, according to Weiler, ' "mutual recognition" or

[11] M Gardeñes Santiago (n 7) 86. VR Dehousse, 'Integration v Regulation? On the Dynamics of Regulation in the European Community' (1992) 30 Journal of Common Market Studies 383, 396.

[12] A Bernel, *Le principe d'équivalance ou de 'reconnaissance mutuelle' en droit communautaire* (Schultness Polygraphischer Verlag, Zürich, 1996) 136.

[13] JHH Weiler, 'The Constitution of the Common Market Place: Text and Context in the Evolution of the Free Movement of Goods' in P Craig and G de Búrca (eds), *The Evolution of EU Law* (OUP, Oxford, 1999) 365, accrediting the term 'functional parallelism' to Alan Dashwood.

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functional parallelism is . . . a very conservative and fully justified application of the principle of proportionality'.[14]

Nevertheless, a different view of mutual recognition and of its relationship with the concept of functional equivalence is supported here. These constitute two discrete concepts, operating in two different phases of the free movement analysis.[15] Contrary to mutual recognition, the concept of 'functional equivalence' operates as part of the exception, not as part of the rule. Functional equivalence is not a necessary condition to trigger the mutual recognition obligation. It is rather a negative requirement whose fulfilment is necessary, but not sufficient, to derogate from that obligation exceptionally. In other words, in order to be able to derogate from the mutual recognition obligation, no functional equivalence may be present.

To determine if a measure constitutes a restriction, the duty of mutual recognition is applied automatically, irrespective of any assessment of functional equivalence. Such assessment may take place in the second stage of the analysis, within the justification process. As explained in more detail below, the concept of functional equivalence is part of the proportionality test establishing whether a restrictive measure can be justified.

This interpretation is supported by the Court's case law. Starting from *Cassis* and *Saeger*, in the fields of goods and services respectively, the Court has formulated the principle of mutual recognition without any explicit or implicit reference to the equivalence requirement. In *Cassis* and *Saeger* not only the host State's measure was held to be a restriction even though there was no equivalence between the national measures at issue. When determining the existence of a restriction, 'the Court was simply not interested in the question' of equivalence.[16] 'It was enough that the activities were lawful in the country of origin'.[17]

In *Saeger*, only when it had to determine whether derogation to the freedom was possible in the case at hand did the Court make reference to the functional equivalence between the national measures, and include it among the requirements necessary to allow the derogation. In the words of the Court:

[14] ibid 367.

[15] For the same view see N Bernard, 'Flexibility in the European Single Market' in C Barnard and J Scott (eds), *The Law of the Single European Market. Unpacking the Premises* (Hart Publishing, Oxford and Portland, 2002) 101–22, 104. On this interpretation see V Hatzopoulos, *Le principe communautaire d'équivalence et de reconnaissance mutuelle dans la libre prestation de services* (Athènes, Bruylant, 1999) 67 ff; KA Armstrong, 'Mutual Recognition' in C Barnard and J Scott (eds), *The Law of the Single European Market. Unpacking the Premises* (Hart Publishing, Oxford and Portland, 2002) 225–67, 249. A Mattera, 'Les principes de "proportionnalité" et de la "reconnaissance mutuelle" dans la jurisprudence de la Cour en matière de libre circulation des personnes et des services: de l'arrêt "Thieffry" aux arrêts "Vlassopoulou", "Mediawet", et "Dennemeyer"' (1991) 4 Revue du Marché Unique Européen 191–203.

[16] J Snell, *Goods and Services in EC Law. A Study of the Relationship Between the Freedoms* (OUP, Oxford, 2002) 61.

[17] ibid.

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> [A]s a fundamental principle of the Treaty, the freedom to provide services may be limited only by rules which are justified by imperative reasons relating to the public interest [. . .], *in so far as that interest is not protected by the rules to which the person providing the services is subject in the Member State in which he is established.*[18]

To stress the distinction between mutual recognition and functional equivalence, it is important to note that the equivalence requirement entered into ECJ jurisprudence before the mutual recognition principle. The equivalence requirement was first introduced in a 1979 case (*Van Wesemael*), 12 years prior to the *Saeger* case. The function of the equivalence requirement in *Van Wesemael* and in other cases before *Saeger* was the same as it would have been in the subsequent '*Saeger* case law': *to narrow the exception to the rule* prohibiting restrictions to free movement of services.[19] Before *Saege*r that rule only amounted to non-discrimination; from *Saeger* onwards it also contains the principle of mutual recognition.

In the light of this consolidated jurisprudence, it is worthwhile to see in more detail how functional equivalence restricts the possibility to derogate from the freedom of services, with particular attention to the field of financial services. As mentioned above, a barrier to the freedom of services can be exceptionally justified only if it conforms to the principle of proportionality. One of the elements of the principle of proportionality is the test of necessity, which includes the requirement of (non) equivalence. A measure is necessary (under the proportionality principle, and thus a restriction to the freedom may be acceptable) if inter alia the purported objective is not already achieved by the law of the provider's home State (if there is no functional equivalence). But if functional equivalence is present (if the provider's home State law already achieves this objective) there is no longer any possibility to derogate from the freedom of services.

It is thus necessary to ascertain whether the law of the host State and the home State are functionally equivalent with regard to the protection of the interest at issue. The two States, regardless of the methods used,[20] must achieve the same degree[21] of protection of the public interest. If the objective

[18] Case 76/90 *Saeger v Dennemeyer* [1991] ECR I-4221, para 15. Emphasis added.

[19] Joined Cases 110 and 111/78 *Van Wesemael* [1979] ECR I-35, para 28: 'Specific requirements imposed [by the host State] on persons providing services cannot be considered incompatible with the Treaty . . . in so far as the person providing the service is not subject to similar requirements in the Member State in which he is established.' See J Snell (n 16) 183.

[20] The equivalence must exist between the objectives and not necessarily between methods and instruments adopted to achieve such objectives. V Hatzopoulos (n 15) 71; M Gardeñes Santiago (n 7) 60.

[21] The objective is not the same if the degree of protection of the public interest at which the laws aim is different. This, however, does not mean that Member States enjoy limitless freedom in determining the level of protection. The third derogation test (the proportionality test *stricto sensu*) restricts such freedom. With regard to the equivalence between two national investor-protection legislations see Case C-384/93 *Alpine* [1995] ECR I-1141, and the relative Opinion of AG Jacobs, para 90.

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of the host State is achieved by the application of home State rules, the restriction is not necessary and thus cannot be justified.[22]

As the field of financial services well exemplifies, the equivalence test must be carried out not only in respect of regulation but also in respect of enforcement (understood here to include supervision).[23] Two national laws are not functionally equivalent even though they impose the same substantive requirements on a firm, if their enforcement mechanisms do not have the same degree of effectiveness.

For example, in *Alpine*[24] the Court held that there was no functional equivalence between the law of the two States involved with respect to the practice of 'cold calling' (contacting individuals by telephone without their prior consent in order to offer them financial services or instruments). The host State was viewed as incapable of ensuring the same protection to investors established on its territory compared with the protection provided by the intermediaries' home State (the Netherlands). The restrictive measure imposed by the home State was justified because it was regarded as necessary. And it was deemed necessary because its purpose (the protection of investors) could not be achieved by the host State.

> The Member State from which the telephone call is made is best placed to regulate cold calling. Even if the receiving State wishes to prohibit cold calling or to make it subject to certain conditions, it is not in a position to prevent or control telephone calls from another Member State without the cooperation of the competent authorities of that State.[25]

Similarly, two national laws should not be considered as functionally equivalent in the pursuit of, for example, financial stability of banks or of investor protection, if only one of these laws provides for special administrative supervision, and if only one State relies on both private and public enforcement of prudential and investor-protective rules. In such a case the protection of the above interests would not be equivalently effective in the two legal systems.

Lastly, services supplied to clients established abroad might not be supervised, at least not adequately, by the intermediary's home State authorities. Supervisory authorities might not verify whether domestic intermediaries comply with domestic investor-protection regulation when they interact with investors established abroad because the national law's ambit of application is limited to activities carried out within the territory of that State. Inadequate supervision, on the other hand, might be caused by the lack of necessary

[22] Case 279/80 *Webb* [1981] ECR I-3305, para 21.

[23] Case C-293/93 *Houtwipper* [1994] ECR I-4249, para 27. Case 205/84 *Commission v Germany (Insurances)* [1986] ECR I-3755, paras 36 ff. In the literature, on the equivalence between national control mechanisms, see A Bernel (n 12) 85 ff; M Gardeñes Santiago (n 7) 214, n 100.

[24] Case C-384/93 *Alpine* [1995] ECR I-1141.

[25] ibid, para 48.

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financial and/or human resources on the part of supervisors, which thus limit their monitoring to intermediation activities taking place within national borders.

In all the above cases, the host State—provided that the other conditions required by the ECJ are fulfilled—may derogate from the duty of mutual recognition and impose on foreign intermediaries its own rules and supervision.

B. Who Is Under the Obligation to Recognize What?

A few considerations about mutual recognition's subjects (who is under the duty to recognize) and objects (what is to be recognized) are in order here. Beginning with the objects, the function of mutual recognition is to enable service-providers to remain subject to a single national law. The expression national 'law' is used here to refer to any type of State intervention on the provider's activities. The State intervention may be of a regulatory nature (rule-making) and of a supervisory nature (enforcement). The coordination between national legal systems pursued through the principle of mutual recognition encompasses all aspects of State activities that interfere with the provision of services.

The principle of mutual recognition applies to rules of private and public law. For present purposes, a rule is to be classified as a 'private law' or 'public law' rule depending on the type of legal consequences that attach to its breach. Public law rules (and public law relationships) exist if administrative or criminal consequences follow from a breach (such as pecuniary sanction, imprisonment). If, on the other hand, the consequences are of a private law nature (for example, the nullity of contract, the counterparty's right of compensation or restitution), these are obviously private law rules (and relationships).[26]

The distinction between private and public law rules usually corresponds to the distinction between private and public enforcement, in the sense that private and public law rules are enforced respectively by means of private and public enforcement. Private law claims are usually brought before civil courts, whereas criminal and administrative rules are enforced respectively by criminal and administrative bodies. If the same rule has both private and public law consequences it means that its breach can trigger both civil and administrative/criminal actions.

The cross-border provision of services can be restricted both by private and public law requirements. Hence, the host State must recognize—in the sense specified above—both the private and the public law regime to which the

[26] It is important to note that a rule can be a private and a public law rule simultaneously. In such cases the breach of the rule can trigger consequences both of a public law nature (eg criminal, administrative sanctions) and of a private law nature (eg liability in tort).

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provider is already subject. With respect to cross-border financial services that are already subject to another State's public law (such as banking prudential regulation), the host State may not in principle (that is, unless justified) apply to such services its own public law regulation. The same prohibition applies to private law rules. If, for example, the contractual relationship between the intermediary and the investor is as a result of the parties' choice of law, subject to the law of a certain Member State, civil courts may not apply a rule from another jurisdiction. The intermediary would otherwise be subject to a double set of contractual rules, in breach of the mutual recognition principle.

As regards the subjects of mutual recognition, the above example shows how the principle of mutual recognition might bind not only the provider's host State, but also his home State. Generally the law of the home State must be recognized by other Member States. This is usually because it is the law of these other States that, if applied, would create a 'second regulatory burden', in the sense that they would add another layer of rules on top of the home State regulation with which the provider is already complying. To put it simply, the mutual recognition obligation binds the State that comes second.

Occasionally it is the provider's home State that comes second, and which is consequently under the obligation to recognize the law of another State. This may happen whenever the provider is in the position to choose to be governed by the law of a State other than his home State. Save for exceptional cases, this possibility exists only with regard to private law regulation. The chosen law, with respect to contractual relationships, may be that of the host State, but it may also be the law of a third State. In either case, the home State (in addition to the host State, in the latter hypothesis) is bound by the mutual recognition principle. The home State is under the obligation to exercise self-restraint. It must apply the contract law of another State (the host or the third State), unless it has a valid justification not to.

This interpretation is not directly supported by judicial precedent. At least in the field of services, to date the Court has never been asked to enforce the mutual recognition principle on the provider's home State. For this reason the above reading does not fit the *Saeger* formula, in which the provider is complying with home State rules ('where he *lawfully* provides its services'); in the hypothetical scenario above, the provider is instead complying with the rules of another State. However, the interpretation supported here seems to be sound since it is based on the underlying purpose of the mutual recognition principle, which is to strike down any additional layer of regulation that a State imposes on a provider already regulated.

C. The Legal Effects of Mutual Recognition

The principle of mutual recognition, as it is interpreted by the Court, produces the negative effect of limiting the exercise of national functions (usually, but not exclusively, those of the host State), in particular the functions of rule-

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making and enforcement. The principle of mutual recognition establishes when a State may *not* exercise such functions; for instance, in principle the host State may not impose additional requirements on a provider who is established in another State and who is already complying with the rule of that latter State.

The question to be addressed is whether mutual recognition also produces the positive effect of allocating competences and responsibilities, working as a 'conflict-of-laws rule' with respect to public and/or private regulations. In other words, does mutual recognition mandate the law of a certain State? To simplify the analysis, the most common scenario will be examined, in which mutual recognition obliges the host State to recognize the law to which the foreign provider is already subject in his home State. In this case, does the mutual recognition rule elect the law of the provider's home State as the law applicable to the *private law* aspects of the provider's activity, and/or as the law applicable to the *public law* aspects? It is submitted that the answer should be in the negative, as regards both the private and the public law aspects of regulation.

As regards public law relationships, the principle of mutual recognition does not allocate any competence or responsibility. In particular, in the above scenario, it does not allocate the regulatory capacity to the home State. It does not in itself grant the power to, nor impose the responsibility on, the home State to lay down and to enforce public law regulation governing the supply of services by providers established on its territory.[27] The principle is 'directed' at the host State, not at the home State. It prohibits the former from regulating the foreign service-provider that is already lawfully providing similar services in his home State.

This interpretation is confirmed by the Court's case law. In *Alpine*[28] the Court was asked to judge the compatibility with Article 49 EC of a measure imposed by the home State. As mentioned above, at issue was a ban imposed by the Netherlands on financial intermediaries prohibiting them from engaging in the marketing practice of 'cold calling'. A similar ban was held to constitute a restriction on the freedom to provide services because it also affected offers made to potential recipients in another Member State. However, the restriction was justified as necessary to protect investors and consequently the good reputation of national financial markets.

What is noteworthy is that the Court, in assessing whether the restriction could have been justified, stated that 'the protection of consumers in the other Member States is not, as such, a matter for the Netherlands authorities',[29] for the authorities of the provider's home State. The Court thus rejects the idea

[27] For the opposite interpretation see, eg, N Bernard, 'La libre circulation des marchandises, des personnes et des services dans le Traité CE sous l'angle de la competence' (1998) 34 Cahiers de droit européen 11, 32 ff; N Bernard (n 15) 105.

[28] Case C-384/93 *Alpine* [1995] ECR I-1141.

[29] ibid para 43.

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that the freedom to provide services, and more specifically the (judicial) principle of mutual recognition, allocates regulatory jurisdiction. The judicial principle of mutual recognition does not allocate to the home State the competence and responsibility to regulate cross-border activities carried out by providers established on its territory.

In *Germany v Parliament and Council*[30] the Court was even more explicit in this regard. At issue was Article 4(2) of Directive 94/19/EC concerning bank deposits insurance.[31] In the division of competences and responsibilities between the home and the host State, it allocates a certain competence to the latter.[32] In that case the Court explicitly denied that 'the principle of home State supervision' constitutes 'a principle laid down by the Treaty'.[33] According to the Court, therefore, the fundamental freedoms, and more generally EC Treaty rules, do not impose the application of the home State legislation. It can be inferred that the Treaty imposes on Member States, pursuant to the judicial principle of mutual recognition, the obligation not to exercise their sovereign functions with regard to an already regulated service.

The judicial principle of mutual recognition does not allocate competences or responsibilities to a particular State with respect to private law relationships either.[34] In particular, this principle does not elect the law of the provider's home State as the law applicable to the private law aspects of the provider's activity.

This point about the Court's case law (*Alpine* and *Germany v Parliament and Council*) in relation to public law relationships must necessarily be extended to the regulation of private law relationships too. The principle of mutual recognition has been principally applied with a view to removing obstacles stemming from the existence of multiple 'public laws'. Hence it would be unreasonable if it were applied to the effect that Member States find themselves restricted more in the field of private law than in the field of public law.

The principle of mutual recognition resulting from the Court's interpretation of the EC Treaty rules on the free provision of services has always been

[30] Case C-233/94 *Germany v Parliament and Council* [1997] ECR I-2405. A Landsmeer and M Van Empel, 'The Directive on deposit-guarantee schemes and the directive on investor compensation schemes in view of Case C-233/94' (1998) July–Aug European Financial Services Law 143–52.

[31] Directive of the European Parliament and of the Council of 30 May 1994, OJ L 135/5.

[32] Art 4 (2) requires Member States to include in their deposit-guarantee schemes the branches of credit institutions authorized in other Member States so that they supplement the guarantee already enjoyed by their depositors on account of their affiliation to the guarantee system of their home Member State.

[33] Case C-233/94 *Germany v Parliament and Council* [1997] ECR I-2405, para 64.

[34] V Hatzopoulos (n 15) 85 ff does not deem the (judicial) principle of mutual recognition to be a conflict rule either. Some commentators think differently; see A Gkoutzinis, 'Free Movement of Services in the EC Treaty and the Law of Contractual Obligations Relating to Banking and Financial Services' (2004) 41 CML Rev 119, 146 ff; M Fallon and J Meeusen, 'Private International Law in the European Union and the exception of mutual recognition' (2002) 4 Yearbook of Private International Law 37–66.

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applied as an instrument of negative harmonization: to limit Member States' exercise of sovereign functions. The negative character of the mutual recognition principle means that the latter may not be interpreted as a rule of private international law, electing the provider's home State law as the applicable law.

The above does not mean that the obligation of mutual recognition does not influence the functioning of private international law. Conflict rules—just as all national rules—must be compatible with the freedom to provide services, and, thus, with the principle of mutual recognition.[35] It is submitted that a rule of private international law that results in a double set of national rules (double burden) being imposed on the provider impinges on the freedom to provide services, and it is thus prima facie unlawful.[36] A private international law rule constitutes a restriction on the free provision of services when it provides for the application of a law to a situation that is already subject to the law of another State. The latter State is often, but not necessarily, the provider's home State. For example, in the case of contractual parties choosing as the applicable law the law of the provider's home State, under the principle of mutual recognition the court may not apply the rules of a law other than the law chosen by the parties, unless there is a valid justification.

IV. THE 'LEGISLATIVE' PRINCIPLE OF MUTUAL RECOGNITION

In the discussion of mutual recognition as a conflict-of-laws rule for either public or private law, it is important not to confuse the principle of mutual recognition as it is applied by the Court with the principles of 'home country rule' and 'home country control' provided by EC secondary legislation. There is a *judicial* principle of mutual recognition, and a *legislative* principle of mutual recognition.[37] In terms of effects, the difference is that, whereas only limitative effects take place by virtue of the judicial principle, the legislative principle also provides for the allocation of specific competences and responsibilities to a

[35] LG Radicati di Brozolo, 'L'influence sur les conflits de lois des principes de droit communautaire en matière de liberté de circulation' (1993) 82 Revue critique de droit international privé 401–24.

[36] The issue of when conflict-of-laws rules are to be regarded as restrictions to free movement across Member States has come up recently in relation to cases concerning the relationship between private international law in the field of company law and the freedom of establishment. Case C-208/00 *Überseering* [2002] ECR I-9919 is particularly relevant to the present analysis, as it deals with a 'situation' being subject to two conflicting national legislations. A company formed in accordance with the law of a Member State is deemed, under the conflict-of-law rule of another Member State, to be non-existent. The obligation to recognize each other's laws is breached at its core: a company is a creation of a national law, it can exist and stop existing *only* by virtue of that legislation (see para 67 of the *Überseering* judgment). The other national systems cannot but recognize such existence. Denying legal personality to a foreign company cannot absolutely be justified, as it is 'tantamount to an outright negation of the freedom of establishment' (para 93).

[37] J Pelkmans, 'Mutual Recognition in Goods and Services: An Economic Perspective' (2003), Working Paper 16, European Network of Economic Policy Research Institutes, p 8, uses the terms 'judicial mutual recognition' and 'regulatory mutual recognition'.

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particular Member State.[38] These competences and responsibilities can include rule-making activities, hence the expression 'home State *rule*', and supervision and enforcement activities, hence the expression 'home State *control*'.

As demonstrated here, the legislative principle of mutual recognition is often referred to as the principle of 'home country rule-control' because the State to which the competences and responsibilities are entrusted is usually the provider's home State. But this is not always the case. Sometimes the competent and responsible State is the provider's State of secondary establishment,[39] some other times it is his State of origin.[40]

The legislative principle of mutual recognition has usually been applied in combination with 'essential harmonization' of national laws, that is, a level of harmonization that does not go beyond what is 'necessary and sufficient' to enable the application of the legislative principle of mutual recognition.[41] Mutual recognition and essential harmonization are the elements of the 'new approach' to harmonization. The 'new approach' has been devised by the Commission for two reasons: first, to remedy the failure of the 'old approach' which was based exclusively on a complete and top-down harmonization of national laws; and, secondly, to address the regulatory restrictions that cannot be circumvented through the judicial principle of mutual recognition. These are measures that host States impose on foreign providers, obstructing their movement, by invoking the 'general good' exceptions to the mutual recognition obligation admitted by the ECJ case law.

[38] Contra M Gardeñes Santiago (n 7) 185 ff. On this issue see also KA Armstrong (n 15) 233 ff.

[39] See for example Art 32 (7) of the Directive 2004/39/EC of the European Parliament and of the Council of 21 Apr 2004 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, OJ 2004 L 145/1 [MiFID].

[40] See, eg, Art 3 of the Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market (Directive on electronic commerce), OJ 2000 L 178/1 [ECD]. J Hörnle, 'Country of Origin Regulation in Cross-Border Media: One Step Beyond the Freedom to Provide Services?' (2005) 54 ICLQ 89, 111 ff, draws a distinction between the freedom to provide services and the 'country of origin' rule (contained in the ECD). She argues that there are two differences. The first is that only the freedom of service involves a comparison between the law of the State of origin and the law of the State of destination in order to determine whether there is an obstacle; in addition, unlike the freedom of services, the country of origin is a 'competence rule' (p 113). The second is that only the freedom of services applies to the export of services, in addition to the 'import' of services. I agree that the freedom of services (more precisely its 'mutual recognition' component) does not allocate competences, and that only the freedom of services governs both the export and import of services. However, I do not agree on the first point. As explained in the text below, the comparison between laws is part of the exception to the freedom of services rule, but the country of origin rule is also subject to the same type of exception (as part the proportionality tests) (see Art 3(4) of the ECD).

[41] An exception is the Electronic Commerce Directive, where competences and responsibilities have been allocated without essential harmonization (eg online investment firms' conduct of business rules).

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In the field of financial services, restrictions exceptionally justified by the Court have effects hindering trade which are particularly wide in scope, in the sense that what should be an exceptional situation (that is, a financial services provider being subject to two sets of national laws) has in fact been the norm. As a consequence, the judicial principle of mutual recognition is to be regarded as a necessary but insufficient tool to integrate national markets of financial services.

There are two reasons why the judicial principle of mutual recognition has limited operational effects in the field at issue. First, financial regulatory systems and approaches have traditionally, and at times deeply, varied a great deal across European nations. Such differences can be invoked by Member States to derogate from the obligation of mutual recognition. Without essential harmonization and the legislative principle of mutual recognition, national authorities can invoke the lack of equivalence between national laws in, for example, the field of consumer protection, to impose their own laws on foreign intermediaries and thus to keep the EC market fragmented along national borders. In the banking sector, for example, the Court has stated that prior to the essential harmonization introduced by the Second Banking Directive,[42] there could exist differences between banking legislations (as regards solvency requirements) capable of justifying, by way of the 'general good' exception, the imposition by host States of conditions regarding access to the activity of foreign credit institutions and their supervision.[43]

The second reason explaining the limits of the judicial principle of mutual recognition as a tool of financial markets integration is connected to a characteristic of financial services regulation. This characteristic greatly differentiates the latter from the regulation of goods, in relation to which the principle of mutual recognition has first been introduced. In order to pursue the stability of the financial system and the protection of consumers, financial services must be subject not only to a pervasive substantive regulation, but also to a *continuous* administrative supervision. This means that trust between Member States—a necessary precondition for the functioning of mutual recognition—

[42] See text below.

[43] Case 222/95 *Parodi v Banque de Bary* [1997] ECR-I 3899, paras 22–6. The judgment, however, should not be read as supporting the conclusion that in business areas such as banking, particularly sensitive to 'general good' concerns, 'judicial' mutual recognition does not apply (or work) at all, and that only the 'legislative' principle of mutual recognition applies. In that very same judgment (para 29), for example, the Court states that, as regard the protection of a bank's borrowers, there may be cases where, because of the nature of the loan and the status of the borrower, the application of borrower-protection rules of the host Member State is not needed and thus not justified.

A different argument is that the judicial principal of mutual recognition in the financial services sector is often not applied even though all the legal conditions necessary for its application are satisfied. As argued below, because of inadequate enforcement of EC law, the 'general good' exception clause in the field of financial law is often abused, that is, invoked without being supported by the conditions required by the proportionality principle. The objective behind such practice is generally of a protectionist nature.

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must exist not only with regard to the content of national substantive regulations, but also with regard to national supervisory and enforcement activities. This is linked to the points above on the equivalence between national laws. With respect to foreign intermediaries, the host State may derogate from the judicial principle of mutual recognition if it proves, inter alia, that the home State's enforcement activity is not equivalent to its own, or, not as effective and efficient in preventing and punishing intermediaries' unlawful conduct; for example, the home State that does not provide the same level of protection to investors resident in the host State as that provided by the latter, or vice versa.[44] The likelihood that trust between Member States with regard to their respective enforcement activities can be established appears to be quite low. As stated above, there does not follow from the judicial mutual obligation any obligation for home State authorities to regulate and supervise the activity of a domestic intermediary carried out outside national borders.

In sum, the judicial obligation of mutual recognition is not sufficient in bringing about a truly free movement of financial services. Legislative intervention, based on harmonization and the legislative principle of mutual recognition, is necessary.

Not surprisingly one of the areas in which the 'new approach' (the 'legislative' principle of mutual recognition included) has been applied the most has been that of financial services.[45] For example, mutual recognition has been applied by the European legislator to coordinate national prudential regulation and supervision in respect of banks and investment firms operating in more than one Member State through establishment and/or cross-border provision of services. Under the legislative principle of mutual recognition, the competence and responsibility to lay down and enforce prudential rules has been given to the State in which the bank has been authorized or the investment firm has its registered office (the home State).[46] The home State has not only the competence, but also the responsibility imposed by EC law to regulate and supervise for prudential reasons 'its' banks and investment firms at all times and wherever they operate within the EC market. Other Member States in

[44] See Case C-384/93 *Alpine* [1995] ECR I-1141.

[45] In financial services the new approach was first adopted in 1989 in the Second Banking Directive (89/646, OJ 1989 L 386/1, now part of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), OJ 2006 L 177/1 (hereinafter the 'Recast Banking Directive'). It is interesting to note, however, that the First Banking Directive of 1977 already envisaged mutual recognition of banking regulations as the objective to aim at (Directive 77/780 OJ 1977 L 322/30, third Recital). Furthermore the home country control principle had been introduced in the field of financial services by Directive 85/611 (OJ 1985 L 375/3) relating to undertakings for collective investment in transferable securities (UCITS). The new approach was extended from banks to investment firms by Directive 93/22/EEC on investment services (OJ 1993 L 141/27) [ISD], to be replaced by the MiFID.

[46] Exceptionally, under Art 27 of the Consolidated Banking Directive, host Member States shall retain responsibility in cooperation with the competent authorities of the home Member State for the supervision of the liquidity of the branches of credit institutions pending further coordination.

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which foreign firms have a fixed establishment or provide services (host States), may not impose on these banks and investment firms their prudential laws and supervision.

To enable every Member State to trust the ability of the other jurisdictions to protect the financial stability of intermediaries and of the system as a whole, and, thus, in order to make the application of the legislative mutual recognition principle possible in the prudential field, the EC legislator has had to introduce essential harmonization of national prudential regulation. Being essential, such harmonization only concerns those differences between national regulations that States may invoke under the 'general good' exception to restrict freedom of movement. The other differences are left untouched, as it is possible for intermediaries to circumvent them by virtue of the duty of mutual recognition. The intent is to ensure that every Member State applies to 'its' banks and investment firms those specific rules that are deemed by all Member States to be necessary and sufficient to ensure the financial stability of banks and investment firms. Once it is ensured, through 'essential harmonization', that in every Member State the necessary regulation to guarantee financial stability of banks and investment firms is in place, Member States can be prohibited from invoking the residual disparities of national laws as a justification to restrict the activities of foreign banks or firms.

Like its judicial counterpart, the legislative principle of mutual recognition is subject to exceptions. Derogations from the home country rule (or country-of-origin rule, etc) may be of three different types. In the first type, *parts* of the same type of regulation (eg banking prudential regulation or business conduct regulation) which generally falls under the home country rule-control, are exceptionally entrusted to the competence and responsibility of another State, possibly because this latter State is able to carry out the responsibility at issue more effectively.[47] As to the second type of exceptions, in a matter falling under the home country rule-control, a different State may be allowed to intervene on an exceptional basis and under certain conditions.[48] In the third

[47] eg, in regulating investment firms' right of secondary establishment, the MiFID provides that '[b]y way of derogation from the principle of Home country authorisation, supervision and enforcement of obligations in respect of the operation of branches, it is appropriate for the competent authority of the Host Member State to assume responsibility for enforcing certain obligations specified in [Art 32 (7)] of this Directive in relation to business conducted through a branch within the territory where the branch is located, since that authority is closest to the branch, and is better placed to detect and intervene in respect of infringements of rules governing the operations of the branch.' Recital 32 of the MiFID.

[48] eg Art 62 (1) of the MiFID, governing the power-duty of the host State to apply precautionary measures to a foreign investment firm that is 'acting in a manner that is clearly prejudicial to the interests of host Member State investors or the orderly functioning of markets … ' Art 3 (2) and (4) of the ECD provides for a series of substantial and procedural requirements that a Member State must meet before it may impose, in the 'coordinated field', its rules on cross-border online suppliers established in a different Member State (State of Origin). Elsewhere the conditions required by European legislation in order to derogate from the legislative principle of mutual

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type of exceptions, the home State's responsibility and competence does not apply simply because the matter at hand is not covered by the home country rule, possibly as national laws are not yet sufficiently harmonized.[49] In this latter case, only the judicial principle of mutual recognition applies.[50]

V. HAS MUTUAL RECOGNITION WORKED AND WHAT WILL BE ITS ROLE IN THE FUTURE?

Mutual recognition—in its legislative and judicial forms jointly considered—has not brought about a properly integrated European financial market. It is thus necessary to ask what has not worked, and what is currently underway or can be done to correct the situation.

The failure of the 'new approach' has various causes of European and national origin. European institutions have failed to carry out two tasks. They have not been able to introduce the necessary condition for the functioning of mutual obligation: the essential harmonization of national laws. And they have been unable effectively to enforce EC obligations on Member States.

As regards the first failure, financial legislation adopted under the 'new approach' by the European legislature has been shown to be incomplete and defective.[51] Various and important aspects of financial markets have lacked a European-wide regulation, precluding the application of mutual recognition.[52] The lack of fundamental EC financial regulation is at the heart of the reason

recognition amount to the conditions provided for in the ECJ case law to derogate from the judicial mutual recognition. The European legislator usually refers to these conditions using the 'general good' clause. See, eg, Art 19 (6) of the ISD.

[49] eg the 'country of origin' rule of the ECD does not apply to certain sectors listed in the Annex to the Directive.

[50] This is often expressly stated in EC legislation itself through the inclusion of a 'general good' exception clause. For example, Art 37 of the Recast Banking Directive stipulates that credit institutions may advertise their services in host Member States but 'subject to any rules governing the form and content of such advertising adopted in the interest of the general good.' The 'general good' reference means that the exercise of regulatory and supervisory powers as regards advertising, as it is not covered by home country rule-control, is subject to the freedom of services regulation and its exceptions. The host State may derogate from the judicial principle of mutual recognition if and to the extent that the three proportionality (or 'general good') tests are met.

[51] See the assessment of EC securities regulation carried out by the Committee of Wise Men on the Regulation of European Securities Markets ('Lamfalussy Committee'), resulting in the adoption of two reports: the Initial Report (Nov 2000), and the Final Report (hereafter called 'the Lamfalussy Report') (Feb 2001). The Committee was set up in July 2000 by the Economic and Finance Council of the EU (Ecofin) with the task, inter alia, of assessing the effectiveness of EC securities regulation in integrating national markets. On the reforms proposed by the Committee, see below.

[52] A comprehensive market abuse regime, rules on takeovers, and on alternative trading systems, conduct business rules of investment firms, were some of the highlighted regulatory lacunae.

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for the Commission's Financial Services Action Plan ('FSAP').[53] Before such programme, where harmonized rules have been adopted, various regulatory defects have obstructed the full or smooth functioning of the legislative principle of mutual recognition. These shortcomings have concerned, first, the lack of clarity of numerous rules and legal concepts contained in the legislation (for example, the 'general good' exception clause), which has been particularly detrimental to the business need of legal certainty. And, second, the level of harmonization, which has not been sufficiently high in some areas (such as investor protection) for the home country rule/control principle to apply. In this regard, it is important to stress that harmonization must be understood in a wider sense than it has been traditionally. Harmonization should not only refer to laying down identical or similar rules. It must also include uniform application and interpretation of such rules by national authorities. It is not rare that host State authorities do not 'recognize' a foreign intermediary's home State regulation, and thus do not allow it free access, because they regard such regulation not to be a correct interpretation of rules agreed upon at EC level.[54]

The EC has also failed in monitoring Member States' compliance with EC law, and with the judicial principle of mutual recognition in particular.[55] The lack of effective enforcement by the Commission is seen as having been one of the most important factors determining the non-integration of markets in financial services.[56] As discussed below, the Commission in particular should have been more aggressive in curbing the protectionist use of the 'general good' exception by Member States.

For the failure fully to integrate national markets, the responsibility of Member States is intertwined with that of EC institutions. To be sure, sometimes the lack of a proper level of harmonized regulation (and of equivalence between national rules) has *legitimately* impeded Member States to open up their markets pursuant to the principle of mutual recognition. In other words, sometimes the differences between national substantive regulations and enforcement systems are effectively of such a degree that Member States

[53] European Commission, Financial Services: Implementing the Framework for Financial Services: Action Plan (COM(1999) 232 final). In the FSAP—endorsed by the Lisbon European Council in March 2000—the Commission proposed a number of measures and a timetable of legislative actions in the field of financial instruments and services necessary for the integration of national markets.

[54] The host State is not entitled to use such argument and obstruct the free movement of firms. If, in its view, the home State is not applying harmonized regulation correctly, the host State—apart from possible exceptions to the mutual recognition obligation expressively provided for by the EC legislator (eg Art 61 (1) of the MiFID)—may only rely on the general infringement procedures provided for by the EC Treaty (Arts 226 and 227). See M Tison, 'The Investment Services Directive and its Implementation in the EU Member States' (1999) Working Paper 17, Financial Law Institute, 1–35, 19–21.

[55] JHH Weiler (n 13) 368 considers mutual recognition 'a colossal market failure', especially because 'one cannot plan, produce and market product lines hoping that eventually a court decision will vindicate a claim of mutual recognition or functional parallelism'.

[56] The Lamfalussy Report (n 51) 50.

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cannot trust each other, and thus cannot but subject foreign firms to host State regulation.

However, differences in national legislations have often been taken by Member States as a pretext to protect their markets from foreign competitors. Regulatory gaps, unclear rules and exceptions to the legislative principle of mutual recognition existing in EC regulation of financial markets would not have been as detrimental to the integration cause as they have been, had Member States fully complied with the judicial principle of mutual recognition. The requirements set out by the proportionality principle, under the 'general good' doctrine, have often been disregarded. Host States have exercised their rule-making and enforcement activities with respect to foreign providers regardless of the latter's home State rules and supervision. This has occurred, for example, in the field of investment firms' business conduct rules (under Article 11 ISD). Host States have most often disregarded the requirements imposed by the Court. In 2000 the European Commission stated that 'domestic conduct of business rules are applied to incoming investment services . . . even though the country of the service provider itself enforces important, other comparable and equivalent, elements of conduct of business protection.'[57]

'Better regulation' and 'better enforcement' are necessary to make the principles of mutual recognition work. Both needs are addressed by the Lamfalussy process, which has reformed the way financial regulation is adopted at EC level, and then implemented and applied at national level. The following section will only highlight those aspects of the reform that are the most relevant to the study of mutual recognition, but will not attempt a comprehensive analysis of the Lamfalussy reform. Following this, an explanation is given on the need for 'better regulation' and 'better enforcement', and in what way, and to what extent, such reform brings a solution to those necessities.

A. The Lamfalussy Reform

The Lamfalussy reform[58] is based on the recommendations formulated by the Committee of Wise Men on the Regulation of European Securities Markets,[59]

[57] See Communication from the Commission—The application of conduct of business rules under Article 11 of the investment services Directive (93/22/EEC), COM/2000/0722 final, 11.

[58] The literature on the subject is already vast. See, for example, K Lannoo, 'The Transformation of Financial Regulation and Supervision in the EU' in D Masciandaro (ed), *Handbook of Central Banking and Financial Authorities in Europe. New Architectures in the Supervision of Financial Markets* (Edward Elgar, Cheltenham, 2005) 485–513. G Ferrarini, 'Contract Standards and the Markets in Financial Instruments Directive (MiFID): An Assessment of the Lamfalussy Regulatory Architechture' (2005) Institute for Law and Finance Working Paper Series No 39, pp 9 ff, <http://www.ilf-frankfurt.de/publications/ILF_WP_039.pdf>; E Ferran, *Building an EU Securities Market* (CUP, Cambridge, 2004) 61 ff; G Hertig and R Lee, 'Four Predictions about the future of EU Securities Regulation' (2003) 3 Journal of Corporate Law Studies 359–78.

[59] See n 51.

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set up by the Council of the EU (economics and finance ministers—Ecofin) in July 2000. The Committee was asked to assess the regulation of the securities markets in the European Union and the current conditions for its implementation; to assess how the mechanism for regulating the securities markets in the European Union can best respond to developments underway on securities markets; and to propose as a result, scenarios for adapting current practices in order to ensure greater convergence and cooperation in day-to-day implementation, taking into account new developments in the market, in order to eliminate barriers and obstacles.

The Committee has recommended specific changes with regard to how securities legislation is adopted at EC level, and how the execution of such legislation is carried out at national level. The objective is to make EC regulation more effective, in its ability to address problems in the functioning of securities markets adequately and in a timely manner, and in its ability to be coherently, uniformly and effectively executed at national level. The regulatory and enforcement process suggested by the Committee does not need any amendments to the EC Treaty and it is made of four levels.

The reform was endorsed in March 2001 by the Ecofin Council and by the heads of State and government at the Stockholm European Council and, in February 2002, by the European Parliament and has been adopted since the proposal for the Market Abuse Directive (Directive 2003/6/EC).[60] Furthermore, the Ecofin Council, in December 2002, decided to extend the reform's scope of application from securities to banking, insurance occupational pensions and mutual funds (UCITS).

In level 1 of the Lamfalussy reform the European Parliament and the Council formulate and adopt directives or regulations containing what is politically perceived as the fundamental principles and the essential rules of the regulation governing a certain aspect or sector of the financial market. Level 1 is thus where the fundamental policy decisions relating to specific aspects or sectors of the financial market, expressed by means of framework principles and norms, are taken. Furthermore, in level 1 the European legislator lays down the foundation for what will be the (level 2) technical measures implementing and specifying level 1 framework regulation, and delimits the rulemaking powers delegated to the European Commission for that purpose. In level 1, in addition to laying down the framework regulation, there is the need to decide which of the framework rules must be implemented, that is specified by the Commission at level 2, and the exact nature and extent of such implementing measures. The aspects of the framework regulation that are not included in the delegation are to be implemented and specified directly by national authorities, possibly also in light of the relevant indications emerging from level 3 of the Lamfalussy procedure.

[60] OJ 2003 L 96/16.

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Level 2 involves the implementation of framework principles and rules. In accordance with Article 202, third indent, CE, the Commission is to lay down technical rules which specify some of the level 1 provisions. The institutional and procedural distinction between the framework and implementing technical regulation is designed as a means to reconcile the need to have stable overarching principles democratically decided upon, with the need for detailed, harmonized sets of technical rules capable of addressing all the complexities of financial markets, and, finally, with the need for flexible and easy-to-update technical regulation suitable for keeping up with market practices.[61]

Level 2 measures are adopted by the Commission with the assistance of two types of committees. One is of a 'political' nature, also acting as a comitology committee;[62] the second is of a technical nature and is not part of the comitology procedure. Depending on the specific sector of the financial markets at issue, the comitology committee and the technical committee involved change. If the regulation concerns securities, including mutual funds, the comitology committee is ESC (European Securities Committee) and the technical committee is CESR (Committee of European Securities Regulators). If the regulation concerns banking, the comitology committee is EBC (European Banking Committee) and the technical committee is CEBS (Committee of European Banking Supervisors). If the regulation concerns insurance or pensions, the comitology committee is EIOPC (European Insurance and Operational Pensions Committee) and the technical committee is CEIOPS (Committee of European Insurance and Occupational Pension Supervisors).

The 'political' committees are composed of high level representatives of Member States and chaired by a representative of the Commission. They have a dual task: on the one hand, they are consultancy bodies assisting the Commission in the drafting of EC legislation proposals (level 1) relating to their specific field (banking, insurance, etc) of competence. On the other hand, these committees act as comitology committee, and thus are involved in the process, led by the Commission, of formulating and approving implementing technical measures. This latter activity is governed both by the Lamfalussy reform (level 2) and by the 1999/468/EC Council Decision on comitology.

[61] See Explanatory Memorandum (I.3) introducing the Proposal for a Directive of the European Parliament and of the Council on investment services and regulated markets, and amending Council Directives 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC, COM(2002) 625 final—COD 2002/0269, OJ 71 E, 25/03/2003, p 62.

[62] Under Art 202 EC, the Council (together with the European Parliament, when the latter acts as co-legislator) may confer on the Commission the power to execute European legislation. 'Comitology' refers to the procedures under which implementation committees (the so-called 'comitology committees'), composed of policy experts from the Member States, assist the Commission in carrying out that task. These procedures are governed by Council Decision 1999/468/EC on comitology (OJ 1999, L 184/23).

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The 'technical' committees are both independent consultancy bodies assisting the commission, and *fora* aimed at making cooperation and exchange of information among national supervisors possible. They are composed of high level representatives of national supervisory authorities. The activities of such committees, external to comitology rules, are subject to the rules of the Lamfalussy reform. Their task is twofold: to assist the Commission in the drafting of level 2 implementing measures in their field of competence, and, as will be explained, to ensure the uniform, timely and effective application of EC regulation in Member States (level 3).

Level 3 addresses the need to ensure that level 1 and 2 European regulation is implemented, interpreted and applied *uniformly* by all the Member States, and in such a way as to be *effective* in fulfilling its underlying objectives. The dual objectives of uniformity and effectiveness of regulation *lato sensu* (that is, encompassing the activities of rule-making and of enforcement) is pursued by providing that, at level 3, the implementation and application by national authorities of EC regulation be 'assisted' and guided at EC level by the technical committees.[63] Through the work of such committees the aim is to set up an effective and stable network between national authorities in charge of implementing and applying level 1 and 2 European rules. Such committees are designed to further cooperation among national authorities not only in the implementation, interpretation and application of European rules, but also in the drafting and application of aspects of financial markets regulation not (yet) formally harmonized at EC level.

It is important to stress that the pursued coordination of activities carried out by national authorities concerns not only the formal implementation of EC rules within national legal systems, but also the actual day-to-day application of such rules. The application aspect of financial markets regulation by national authorities cannot but be included in the level 3 efforts of coordination, since such efforts are aimed at making the relevant national regulations *converge* and *effective*. Discrepancies between national legislations can also

[63] The double objective pursued at level 3 of the Lamfalussy reform, concerning the convergence and the effectiveness of regulation and supervision, is easily recognizable when going through the tasks conferred upon the technical committees. See, for example, paras 2 and 3 of Art 2 of 5 Nov 2003 Commission Decision that sets up CEBS. They respectively deal with convergence ('The Committee shall contribute to the consistent application of Community directives and to the convergence of Member States' supervisory practices throughout the Community') and the effectiveness of regulation *lato sensu* (the Committee 'shall enhance supervisory cooperation, including the exchange of information on individual supervised institutions.') Similarly, in the introductory part of CESR Charter, one reads that among the factors contributing to the decision to set up such committee there was also the awareness that '[…] close cooperation and information exchange between regulatory authorities are essential for the successful oversight of the European financial markets'; and that '[…] greater supervision and regulatory convergence' are important 'for the achievement of an integrated internal capital markets in Europe'. As it will be shown below in the text, the goal of strengthening the effectiveness of regulation is pursued not only through the cooperation and exchange of information between national authorities, but also through periodic assessments and comparisons of the various regulatory and supervisory national practices, with a view to establish and spread the best ones.

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follow from diverging interpretations and applications of identically worded provisions, and national supervision over intermediaries operating in various jurisdictions can be inadequate because of the lack of effective cooperation between national authorities.

The cooperation among national regulators within the committees can take various forms, including, for instance, the mutual exchange of information and assistance with regard to consolidated supervision over a multi-jurisdictional banking group.[64] Furthermore, the Lamfalussy reform expressly provides that, through the technical committees, national supervisory authorities cooperate in setting out recommendations, guidelines, and non-binding common standards which should be implemented within national legal systems. These soft law rules must be elaborated also in light of decisions taken at national level pursuant to EC regulation. From this perspective, the goal is to 'codify' all the decisions adopted by national supervisors, with a view to furthering coherent interpretation of common regulation by national authorities and to avoid divergent interpretations and applications of the same set of rules frustrating harmonization efforts.

In order to raise the level of convergence between national regulations in the field of financial services, finally, the technical committees are to mediate in case of conflicting interpretations between two or more national authorities with respect to European regulation to be implemented and/or applied.

Level 4 concerns the need to strengthen the control, on the part of the European Commission, over the application of European regulation by Member States. The Commission is to be assisted by a stronger cooperation among Member States, competent national authorities and the private sector.

B. Centralization of Rule-Making and Enforcement

The Lamfalussy reform has pushed forward the centralization or 'Europeanization' process of financial services regulation. This process concerns rule-making: financial services regulation is increasingly laid down at EC level, providing for much of the detail that was formerly found only in national legislation and regulation. The shift from national to EC level does not, however, concern enforcement (understood here to include supervision). The enforcement of financial services regulation falls under the exclusive responsibility of national authorities. This is confirmed by level 3 of the Lamfalussy process: EC regulation is applied and enforced on market participants by national authorities exclusively. The role of level 3 technical committees, such as CESR, is simply to assist those authorities in carrying out their

[64] For example, in the implementation of the Basle II agreement and of the new EC Directive 2006/49/EC on capital requirements of banks and investment firms, one of the major challenges facing CEBS concerns the improvement of the cooperation between home State and host State authorities so as to make supervision of cross-border groups more effective and efficient.

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responsibilities, by furthering and facilitating closer coordination and cooperation among them. Therefore the principle of home country control remains fully operational; compared with the old ISD regime, its scope is even wider (including for example investment firms' rules of conduct).

However, the possibility that the enforcement of financial services regulation will be located at EC level (in the hands of a European supervisory agency) looms on the horizon of possible legislative reforms. This issue is the subject of discussion particularly with regard to securities regulation. In its final Report the Lamfalussy Committee stated that '[…] it might be appropriate to consider a Treaty change, including the creation of a single EU regulatory authority for financial services generally in the Community'[65] in case the proposed changes failed to be effective in bringing about an integrated market.

Some commentators argue that a European financial regulator-supervisor, as opposed to a system based on a network of national authorities, is more suitable for combating national protectionism on the part of national authorities, for ensuring the uniform application of regulation, for eliminating transaction costs arising from the existence of multiple national regulations, for ensuring the independence and accountability of the regulator, and a rapid and flexible law-making process. A single European regulator-supervisor would also be in a better position to manage and prevent financial crisis situations and to represent and defend European interests in the international arena.[66]

The issue is complex and cannot be addressed here, except for the following observation: the current state of European financial markets calls for a gradual approach to reforms. The assessment as to the right *scope* and *degree* of centralization (to the point of setting up a single European regulator-supervisor) should be carried out on a step-by-step basis. Such an approach provides the best way to prevent regulatory failures. It would be risky, for example, to move ahead and establish a single regulator-supervisor for all financial services if certain activities (such as those that do not cross national borders) prove to be effectively supervised by local authorities; or when (economic, cultural, etc) differences between national markets or specific sectors therein warrant a certain degree of regulatory tailoring around each national market.[67]

In the medium term, we should concentrate on evaluating the merits and faults of the Lamfalussy regulatory and enforcement system, and thus on possibly improving that model. The model combines three different elements:

[65] The Lamfalussy Report (n 51) 41.

[66] For a review of these arguments in the field of securities regulation, see Y Avgerinos, 'The need and the Rationale for a European Securities Regulator' in M Andenas and Y Avgerinos (eds), *Financial Markets in Europe: Towards a Single Regulator?* (Kluwer Law International, The Hague, 2003) 145–82.

[67] K Lannoo (n 58) 505, rightly stresses the particular inadequacy of the 'one-fits-all' regulatory approach with regard to the less developed financial markets of the new EU Member States. As regards the need to match 'regulatory infrastructure' and 'market conditions' in the context of the single regulator discussion, see also E Ferran (n 58) 121–2.

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centralization, central coordination of national activities and decentralization. Attention should be focused on the intermediate element when determining whether, with regard to enforcement, a higher degree of centralization is needed. Central coordination of national functions is carried out especially by the level 3 technical committees of national authorities which are entrusted with the task of promoting regulatory and enforcement cooperation and convergence. Only experience will tell whether such committees are able to carry out that task effectively, and what requires reform if not. It is possible, for example, that these committees will need to be given more powers, such as the power to formulate decisions that are legally binding on their members. Or, it may even be decided to entrust them with certain supervisory functions, making them into a quasi-European Supervisor.

C. The Need to Improve Regulation and Enforcement

As stated above, in order to remedy the malfunctioning of the principle of mutual recognition in the field of financial services, it is necessary to improve the regulation and its enforcement. Better regulation[68] means improving pre-FSAP EC regulation with respect to three different aspects: its scope, its degree of harmonization and its clarity. As to the latter aspect, EC financial regulation must be clear both in its substantive rules and in its allocation of competences and responsibilities. Uncertainties and ambiguities in the content of European substantive regulation, by giving rise to divergent and conflicting interpretations, can endanger the achievement of the goal pursued by essential harmonization: the trust between national authorities in each other's regulation—the necessary precondition for the application of the principle of mutual recognition. Similarly, uncertainties and ambiguities in the coordination of national responsibilities and competences can put at risk the full and smooth functioning of mutual recognition, and, with it, the possibility of financial services providers operating in more jurisdictions while remaining subject to a single set of rules.

EC regulation must also be sufficiently wide in scope and deep in its harmonizing effects to allow the application of mutual recognition to the various aspects of financial regulation, without exceptions. Essential harmoniza-

[68] The expression 'better regulation' used here does not refer to the 'better regulation' policy recently adopted by the Commission. Unlike the Lamfalussy procedure, the latter policy is to be applied to all fields of European legislation, and not just to financial services. The Commission proposed a broad 'Action Plan on simplifying and improving the regulatory environment' (COM(2002) 278, 5 June 2002), as part of the EU White Paper on Governance initiative (COM(2001) 428 final, 25 July 2001). The aim is to develop a new common 'legislative culture' in Europe by improving current procedures, widening the breadth of policy tools employed and simplifying existing legislation. This policy entails consultation, ex-ante and ex-post evaluation, and evidence-based policy-making. There will be detailed consultation and impact assessment prior to legislation. In addition, if any measures were found to be ineffective through ex-post evaluation, they would be re-evaluated.

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tion (the degree of harmonization) of regulatory detail needed to trigger the legislative principle of mutual recognition, might, in some cases, be very high. The first three levels of the Lamfalussy process seem to enhance the ability of the European legislature and national regulators to achieve this degree of harmonization. In particular, cooperation and, in case of conflicting interpretations of EC law, mediation between national authorities are to take place within established committees of national regulators, active at level 3 of the Lamfalussy process. This should strengthen the convergence between national legal systems, from the point of view of both implementation and application (interpretation) of EC regulation, with a view to preventing the above-mentioned cases of non-recognition of foreign regulations.

Better enforcement, on the other hand, means two things. The first is the need to strengthen Member States' trust in each other's supervisory activities. Each State must show that financial services regulation is being enforced with effectiveness on firms operating under its jurisdiction. In the functioning of this objective, some of the newly adopted financial services directives contain rules harmonizing, even though to a very limited extent, national structures of public enforcement.[69] The issue of effectiveness of supervision is addressed at level 3 of the Lamfalussy process, whose objective is improving cooperation and exchange of information between national supervisors and setting up peer-review mechanisms.[70]

Secondly, there is the need to ensure that Member States effectively comply with the judicial principles of mutual recognition and home country rule-control. Pressure on Member States to comply should come from different sources: from 'above', by strengthening the Commission's supervisory role. The Lamfalussy Report has encouraged the 'guardian of the European Treaties' to step up its monitoring activities.[71] Pressure from 'the side' comes by setting up peer-pressure and peer-review mechanisms. The committees of national supervisory authorities (level 3 of the Lamfalussy approach) should be an important factor in this respect. Finally, from 'below', pressure is exerted by improving private complaints mechanisms,[72] and private enforcement, enabling financial services providers and consumers to bring complaints to the

[69] Some FSAP Directives go beyond the usual formula under which enforcement measures must be 'effective, proportionate and dissuasive' (eg Art 14 of the Directive 2003/6/EC on market abuse; and Art 28 of Directive 2004/109/EC on transparency [OJ 2004 L 390/38]). Specific obligations regarding the legal nature, powers and tools of supervisory authorities are laid down. See Arts 48 et seq of the MiFID. CERS has called on national governments to ensure its 25 EU Members have equal powers in terms of strength and scope, stating that: 'Equivalent supervisory powers are a prerequisite for any kind of EU supervisory system to work', Ecofin Meeting, 11 Oct 2005, available at <http://www.c-ebs.org/speeches/SP17.pdf>.

[70] On some of the possible techniques that can be used to render financial supervision more efficient in the EC context see E Wymeersh, 'The Future of Financial Regulation and Supervision in Europe' (2005) 42 CMLR 987, 994–1009.

[71] The Lamfalussy Report (n 51) 40.

[72] It has been noted that, in addition to existing systems for consumer complaints about business practices, it is necessary to add systems for business and consumer complaints about practices of

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Commission concerning, or to challenge before national courts, State measures contrary to mutual recognition.[73]

D. The Lamfalussy Process and the Plurality of National Financial Laws

It is important to stress that the Lamfalussy process is addressing the need for 'better regulation' and 'better enforcement'—here identified as preconditions for a better functioning of mutual recognition—not by abandoning the new approach, but rather by upgrading it. The Lamfalussy approach should not be read in contrast with, but rather as a development of, the new approach of the 1980s and 1990s. The former is a more sophisticated version of the latter, in at least two respects. First, it combines and coordinates a host of devices for market integration and market regulation (including cooperation, mediation and mutual control between supervisory authorities, and stronger enforcement mechanisms) in addition to harmonization and mutual recognition. Second, it streamlines the rule-making process with a view to increasing the degree of harmonization, as regards both substantive regulation and enforcement systems, when needed, and the quality of harmonized rules.

The Lamfalussy approach is meant to bring about a higher level of harmonization, not as a substitute for the mutual recognition system, but, on the contrary, to make that system work. Just as under the new approach, harmonization should not be seen as opposed to mutual recognition but as complementary. In particular with regard to rule-making, the Lamfalussy procedure will certainly reduce the margin of discretion of individual States. However, under the Lamfalussy approach, differences between national legal systems will remain,[74] and consequently so will the rationale for mutual recognition.

Besides the limits imposed by the EC Treaty to the legislative competence of the EC,[75] national legal differences in this field will not completely disappear for at least three reasons.

public authorities in the application of Community law in Member States. Market participants may be reticent in making public complaints about their regulators if they fear that to do so could damage relations and thus impact negatively on their business. See Inter-Institutional Monitoring Group, Third Report monitoring the Lamfalussy Process, 17 Nov 2004, 34.

[73] The Lamfalussy Report (n 51) 40, acknowledged the important role of the private sector in bringing infringements to the attention of the Commission.

[74] And they *should* remain, if one is to believe the benefits of regulatory competition, that is, the competition among rules of different legal systems. Regulatory competition can be defined as a process leading to the alteration of national regulation in response to the actual or potential impact of the mobility of economic factors such as goods, services, and other factors of production on national economic activity (see J-M Sun and J Pelkmans, 'Regulatory Competition in the Single Market' (1995) 33 Journal of Common Market Studies 67–89). Regulatory competition is closely linked to mutual recognition, as the latter, by enhancing unrestricted cross-border mobility, facilitates the former.

[75] It is sufficient to mention the subsidiarity principle (Art 5 EC) and the limits on the scope of EC harmonization action provided for by Art 47 (2) EC. See, on the latter, N Moloney, 'New Frontiers in EC Capital Markets Law: From Market Construction to Market Regulation' (2003) 40 CMLR 809–43.

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The first relates to the rule-making process. The Lamfalussy reforms undoubtedly aim at increasing the degree of common rules applicable to the financial sector. The degree of regulatory detail provided for by the FSAP measures adopted under the Lamfalussy approach is usually very high, and some of these measures provide for maximum harmonization, thus prohibiting home Member States to impose on 'their' financial institutions requirements additional to those laid down at EC level. Furthermore, if level 3 works, national implementation of EC rules, and day-to-day interpretation and application of EC and national rules will also converge. However, this does not mean that EC legal intervention—by way of harmonizing and guiding the activities of national regulators—will cover every single aspect of financial services regulation. A detailed harmonization will only interest those parts of financial regulation on which the EC legislature intervenes at both level 1 and 2. Furthermore, cooperation between national regulators at level 3 will not mean that the day-to-day interpretation and application of EC and national rules will always be the same across the Member States. It is unlikely that national regulators will jointly draw common guidelines or standards on every aspect of financial regulation; or that, in light of the inevitable normative nature of concrete decision-making activities of supervisors, such guidelines and standards will be applied in the same manner everywhere, every time. Common guidelines and standards will probably deal with the most important and the less clear aspects of regulation, and, in the face of the 'case law' continuously emerging from individual supervisory cases at national level, they will be instrumental to convergence in the medium term. For the residual aspects of regulation and in the short-term perspective, mutual recognition will remain the key regulatory element in the interest of legal certainty and free movement.

Secondly, there is the matter of supervision, that is, the activity of monitoring financial services providers, which is left completely in the hands of Member States. For example, in the delicate task of banking prudential supervision, providers would still be supervised by *different* agencies even if rules were exactly the same. Trust between such agencies (such as in each other's competence and diligence), and mutual recognition of each other's decisions and activities are necessary conditions for the whole regulatory structure to work.

Thirdly, financial services providers are not only subject to special financial regulation. Also general rules (belonging to contract law, company law, tax law, etc) apply, in so far as they do not conflict with the special financial regulation. Therefore, disparities between general law rules provided for by the various Member States will still need to be addressed by means of mutual recognition.

VI. CONCLUSION

In Europe, at least for the time being, part of the rule-making and the whole

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enforcement of financial services regulation take place at national level. For this reason, mutual recognition of national laws in this field remains an element of central importance in the creation and regulation of a European internal market. Hence, this article sought to contribute to the analysis of this legal instrument, as several aspects of its functioning often appear unclear. Among the issues addressed were: the need to distinguish judicial mutual recognition from legislative mutual recognition; the need to distinguish the principle of mutual recognition from the principle of functional equivalence; and the need to clarify that the judicial obligation of mutual recognition binds not only the provider's host State but also its home State, forcing the latter to recognize the regulation of a foreign State.

The analysis of mutual recognition has highlighted the weak point in this legal instrument, which explains the partial failure of the new approach in the field of financial services. Mutual recognition needs to be supported by a number of other legal devices, of which the main ones are: a harmonization of national regulation at supranational level which must often be wide and deep; an enforcement mechanism able to effectively guarantee the intermediaries' compliance with their legal obligations, and Member States' compliance with mutual recognition obligation.

The Lamfalussy reform seems to be addressing such needs. However, it will take some time before it is possible to determine the full merits of the project, since the Lamfalussy process has yet to be tested in all its four levels and has been conceived as a work in progress, to be shaped over time in light of its practical applications.

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