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**Research Report**

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# **REFLECTIONS ON THE REGULATION OF EUROPEAN SECURITIES MARKETS**

Alexandre Lamfalussy

This SUERF Study is an extended version of the Annual SUERF Lecture given by Professor Lamfalussy at the Bank of England on May 3<sup>rd</sup>, 2001.

Société Universitaire Européenne de Recherches Financières  
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CIP

Reflections on the Regulation of European Securities Markets

Alexandre Lamfalussy

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## SUERF Lectures

The SUERF Lecture is given each year, on the invitation of the Council of Management, by a distinguished European authority in banking and finance. The series was inaugurated in 1992 by Professor Alexandre Lamfalussy. The lectures have been:

- 'Restructuring of the Financial Industry: A Central Banker's Perspective', A. Lamfalussy, London, 1992.
- 'Monetary Co-operation in a Changing Financial Environment', W. F. Duisenberg, Milan, 1993.
- 'Highly Publicly-Indebted Countries, Monetary Reform and Convergence Towards EMU', Mario Monti, Brussels, 1994.
- 'L'Union Economique et Monetaire dans la Perspective de Europe unie', Jacques Delors, Maastricht, 1996.
- 'Monetary Co-operation Beyond 2000', J.-C. Trichet, Copenhagen, 1997.
- 'The Euro: A Stable Currency for Europe', Otmar Issing, Athens, 1999.
- 'Central Banking and the Choice of Currency Regime in Transition Economies', Willem Buiter, Warsaw, 2000.

In July 2000 the ECOFIN established the *Committee of Wise Men on the Regulation of European Securities Markets* under the chairmanship of Baron Alexandre Lamfalussy. Given the importance of this topic, and the power of the Committee's report, the Council of Management was very pleased when Professor Lamfalussy agreed to deliver the 2001 SUERF Lecture to an invited audience at the Bank of England's conference centre on 3<sup>rd</sup> May. The meeting was chaired by the President of SUERF (David T. Llewellyn) and the Vote of Thanks was given by Professor Lord David Currie (Dean, City University Business School).

The Council of Management of SUERF expresses its thanks to the Bank of England for making its facilities available for the occasion.

Professor Lamfalussy has a long association with SUERF since its creation in 1963.

## **SUERF**

SUERF is incorporated in France as a non-profit-making Association. It was founded in 1963 as a European-wide forum with the aim of bringing together professionals from both the practitioner and academic sides of finance who have an interest in the working of financial markets, institutions and systems, and the conduct of monetary and regulatory policy.

SUERF is a network association of central bankers, bankers and other practitioners in the financial sector, and academics with the purpose of analysing and understanding European financial markets, institutions and systems, and the conduct of regulation and monetary policy. It organises regular Colloquia, lectures and seminars and each year publishes several analytical studies in the form of *SUERF Studies*.

SUERF has its full-time permanent Executive Office and Secretariat located at the Austrian National Bank in Vienna. It is financed by annual personal and corporate membership fees. Corporate membership currently includes major European financial institutions and Central Banks. SUERF is strongly supported by Central Banks in Europe and its membership comprises most of Europe's Central Banks (29 in total, including the Bank for International Settlements and the European Central Bank), banks, other financial institutions and academics.

## **Contents**

<b>Biography Alexandre Lamfalussy</b>	<b>7</b>
<b>Reflections on the Regulation of European Securities Markets</b>	<b>9</b>
<b>Major Problems: An Overview</b>	<b>10</b>
<b>The Committee's Mandate and Working Method</b>	<b>11</b>
<b>Shortcomings of the Current Legislative and Regulatory Process</b>	<b>13</b>
<b>Why Does the Current System Work so Poorly?</b>	<b>15</b>
<b>The Main Components of the Committee's Regulatory Reform Proposal</b>	<b>18</b>
<b>Queries and Objections</b>	<b>24</b>
<b>Developments Since the Release of the Report</b>	<b>26</b>
<b>Concluding Remarks</b>	<b>27</b>
<b>Annex 1</b>	<b>29</b>
<b>Annex 2</b>	<b>35</b>
<b>Annex 3</b>	<b>37</b>



## Biography

Baron Alexandre LAMFALUSSY

Alexandre Lamfalussy was born in Hungary in 1929. He left his native country in 1949. From 1949 to 1953 he studied at the Catholic University of Louvain in Belgium. After that, he spent two years on postgraduate studies at Nuffield College, Oxford, where he obtained a doctorate (D.Phil) in economics. He was visiting lecturer at Yale University in 1961 and 1962. From 1955 to 1975 he worked with Banque de Bruxelles, initially as an economist and then as an economic adviser. From 1965 to 1975 Mr Lamfalussy served first as Executive Director of Banque de Bruxelles and later as Chairman of the Executive Board. In 1975 he became Executive Director of Banque Bruxelles Lambert. Mr Lamfalussy joined the Bank for International Settlements (BIS) in Basle in 1976 as Economic Adviser and Head of the Monetary and Economic Department. Between 1981 and 1985 he served as Assistant General Manager of the BIS before being appointed General Manager in May 1985. He held this post until the end of 1993. From 1<sup>st</sup> January 1994 until 30<sup>th</sup> June 1997, Mr Lamfalussy was President of the European Monetary Institute in Frankfurt.

Since 1997 he has been teaching and conducting research at the 'Institut d'études européennes' of the Catholic University of Louvain in Louvain-la-Neuve. In August 2000 he published a book on 'Financial Crises in Emerging Markets – An essay on financial globalisation and fragility' (Yale University Press, New Haven and London). He was Chairman of the Committee of Wise Men on the Regulation of European Securities Markets set up by the European Council. The Committee released its first report on 9<sup>th</sup> November 2000, and its final report on 15<sup>th</sup> February 2001.





## **Reflections on the Regulation of European Securities Markets**

When some time ago I accepted the invitation to deliver the 2001 SUERF Lecture I did not suspect that I would have to start my lecture by apologising for addressing my chosen topic from a rather special angle. Originally, my intention was to share some thoughts with you on the major challenges facing securities regulators in our global financial markets and to think aloud about the ways and means of meeting these challenges. However, I imagine that today most of you would find this detached academic approach somewhat disingenuous on my part. My objective is to discuss five main issues. Firstly, to review the Committee's mandate and the way it conducted its investigation. Secondly, I will discuss the shortcomings of the current legislative and regulatory process with respect to securities markets' regulation, and therefore why the Committee was established in the first place. In the process, I will discuss some of the reasons why the current system works so poorly. This will be followed by a consideration of the main reform proposals the Committee recommended. I will then address three particular queries and objectives that have been raised about our proposals. Finally, I will briefly outline some of the developments since the Committee reported. Three annexes (from the report) are included: Annex 1 gives an analysis of the responses received on the Initial Report of the Committee, and Annexes 2 and 3 outline the Level 1 and Level 2 Consultation and Transparency mechanisms.

The Committee of Wise Men on the Regulation of European Securities Markets, which had been set up by ECOFIN in July 2000 and which I was asked to chair, released its final report on 15 February of this year. On 23 March the Stockholm Summit approved 90 to 95% of our recommendations and requested that the new regulatory structure should become operational by the end of this year. I will say more about the residual 5-10% in a later section.

Implementation of our recommendations is now underway. While I am confident that it will be carried out according to schedule, it is nevertheless raising problems, and may well raise additional problems in the future. These problems will have to be solved if the new regulatory process is to produce a significant improvement over current practice. A commendable feature of the Stockholm Resolution was that it set out a series of clear principles for the reform of securities markets regulation. Bad habits, however, do not fade away gently. It is important, therefore, that investors, issuers of securities and all market participants keep a watchful eye on the implementation process,

and speak up whenever they detect deviations from the principles so clearly agreed in the Stockholm Resolution.

So my paper will be far from detached. I would like to persuade you to lend your support to the realisation of our Committee's recommendations

### **Major Problems: An Overview**

The central problem can be summarised quite simply: the *current regulatory system is not working*; it is too slow and too rigid, produces too much ambiguity and fails to make a distinction between core principles and detail. Insufficient consultation and transparency, plus uneven transposition and erratic implementation by Member States of agreed Community rules, are real handicaps.

The development of the EU financial market is hindered by a plethora of barriers such as:

- the absence of clear Europe-wide regulation on a large number of issues;
- an inefficient regulatory system;
- inconsistent implementation of existing rules;
- a huge number of transactions, clearing and settlement systems;
- the inadequate development of funded pension schemes.

Other factors slowing market integration are: differences in legal systems and taxation; and political, external trade and cultural barriers.

The *lack of basic European rules* is a major handicap. This is recognised and became the heart of the reason for the Financial Services Action Plan, which should be delivered by 2005 at the latest. The most important gaps are:

- lack of agreed principles covering all financial services legislation;
- failure to make the mutual recognition principle work;
- outdated rules on listing requirements;
- ambiguity over the scope and application of conduct of business rules;
- no appropriate rules to deal with alternative trading systems;
- inconsistencies between the E-commerce Directive and financial services Directives;
- no comprehensive market-abuse regime;
- no cross-border collateral arrangements;
- no set of common accounting standards;
- outdated investment rules for UCITS and pension funds;
- no agreed take-over rules; etc.

### **The Committee's Mandate and Working Method**

Let me remind you of what we considered to be our core mandate: to identify the shortcomings of the current European legislative and regulatory process in the field of securities markets and to make recommendations on remedies for these shortcomings. In other words, this was an action-oriented mandate.

We had to start, of course, with fact finding, analysis and assessment. It did not take us much time to persuade ourselves that significant gains could be derived from building genuinely integrated, liquid, transparent and efficient securities markets in the European Union. At the micro level, such benefits include a more efficient allocation of capital, enhanced liquidity which will benefit all companies and most especially SMEs, a lower cost of capital, higher net yields for consumers, and cheaper cross-border (clearing) settlements. At the macro level a more efficient capital market should enhance the productivity of capital and labour and contribute to stronger growth and employment.

Such markets would help raise the productivity of both labour and capital, and thus contribute to faster growth and job creation. Although this contribution could be substantial, we fully realised that the radical improvement of Europe's growth and employment performance hinged on a number of other developments as well. Nevertheless, our judgement was that the completion of the single market programme will bring substantial benefits across the board. We also judged that an integrated and well-functioning European capital market is an integral part of the overall single market programme. We believe that the implementation of the Financial Services Action Plan cannot in practice be completed by 2004 without the type of reforms our Report recommends. Reform of capital market regulation is an integral part of fulfilling the ambitions of the single market in financial services.

We also quickly came to the conclusion that, in contrast with markets for goods and many services, the single market for financial flows and services was very far from being a reality, despite progress in some areas. There was no doubt either that the identified weaknesses or even failures of the European legislative process bore a major responsibility for the inadequate degree of financial integration – hence the justification for remedial action.

Quite clearly, however, it was not part of our mandate to make recommendations on what should, or should not be regulated via European law-making, and even less on the content of specific Directives or

Regulations. On the other hand, as our work progressed we gradually realised that the Financial Services Action Plan was a highly ambitious exercise requiring considerable legislative work during the coming years. For the sake of speeding up the process it was essential that priorities be established. Hence our recommended list of priorities – a sort of by-product of our core report, albeit an important one.

The priorities within the Financial Services Action Plan which must be adopted by the end of 2003 are:

- single prospectus for issuers;
- modernised admission to listing;
- home-country control for all wholesale members and a definition of professional investors;
- modernised investment rules for UCITS and pension funds;
- the adoption of international accounting standards;
- a single passport for recognised stock markets.

The Committee of Wise Men also argues that attention needs to be given to three crucial parameters:

- convergence of regulatory and supervisory structures;
- restructuring of clearing and settlement led by the private sector in order to reduce the huge European costs compared to those of the US. If the private sector fails to deliver an efficient system, a public policy lead will be needed. A smooth functioning of clearing and settlements is essential for efficient securities markets and for the infrastructure for monetary policy;
- the management of prudential implications implies the need to strengthen co-operation at the EU level between regulators and institutions responsible for micro and macro supervision.

Throughout this initial work of fact finding, analysis and assessment we always kept in mind that our final report should come up with recommendations on how to improve, as speedily as possible, the legislative process and, by implication, the regulatory structures. In short, we felt ourselves drawn into an exercise in European Governance.

A very substantial part of our work was taken up by consultations. We consulted investors (« consumers »), end-users (issuers of securities) and the full range of intermediaries, as well as regulators, and the three main actors of the legislative process, i.e. the Commission, the Council and Euro MPs. These consultations took the form of organised hearings and/or receiving written submissions in response to our questions posted on the Internet.

The first wave of consultations took place in September and October 2000, leading up to our Initial Report released in November. My original inclination was to draft a rather anodyne, factual and analytical interim report, suggesting perhaps alternative courses of action, yet leaving explicit recommendations to the final report. But we soon came to the conclusion that the shortcomings of the current system were so obvious, and that there was such a wide consensus on what these weaknesses were, that we would just waste our very limited time by digging out more and more evidence confirming the initial findings. Rather, we judged that we should focus our attention on potential remedies. As a result I joined those of my much wiser colleagues who had argued from the outset that we should stick our neck out as early as possible with a view to provoking genuine reactions from all interested parties: market participants, regulators, government and Commission officials, Euro MPs and, indeed, media and the public at large. This is what led us to outline already in our initial report our four-level reform approach (including the setting up of the two new committees) which did, indeed, produce widespread reactions.

We received these reactions during the second wave of consultations in December 2000 and January 2001 and they were summarised in an annex to our final report. This is included as Annex 1 to this paper. This helped us to refine and adjust our initial proposal and to make it more explicitly operational. It also led us to put a much greater emphasis on the need for consultation and transparency throughout the whole of the legislative process. This was the result of our own genuine learning process. In a world of accelerating innovation, changing structures, in matters so technical yet having so broad implications for so many people, enterprises and institutions – let alone for real or perceived national interests – no one can make sensible recommendations without carefully listening to arguments and being ready to enter into a genuine dialogue.

### **Shortcomings of the Current Legislative and Regulatory Process**

The basic principles of the current system are quite simple – but the way it functions in practice is not. The right and duty of taking legislative initiatives belongs exclusively to the Commission which drafts either a Directive or a Regulation. This proposal is submitted for co-decision to the Council (i.e. to Ministers of the Member states – in the area of financial services, to ECOFIN) and the European Parliament. These legislative bodies approve, amend or reject the proposal. The practical complexity is due in part to the fact that the interaction between these three institutions – for instance the amendment

process – is governed by a set of pre-agreed rules known as the ‘comitology’ process. Herein lies one of the problems: these rules are neither simple nor unambiguous. They are the result of historical developments accompanied by protracted negotiations. To varying degrees all three institutions dislike them and try to interpret them according to their own perceived interest. Another cause of complexity is that the implementation of the legally binding Directives rests with the administrations of the Member states; and whenever a Directive contains ambiguous passages these administrations interpret them to their liking. And, of course, these interpretations may be different between different jurisdictions which, in some cases, means that, what was originally designed as a laudable exercise in harmonisation and having markets in different centres subject to equal regulatory requirements, ends up with a complex and sometimes differentiated set of rules and procedures.

We have identified a series of major shortcomings of the current system. I will emphasise three in particular.

To begin with, the legislative process is far too slow. In a number of instances it has taken three to four years between the time the Commission started working on a draft Directive and its effective implementation by the Member states. The worst example is provided by the horror story of the cross-border take-over proposal which was initiated by the Commission as long ago as 1989 and yet has still not been approved (let alone implemented). However, everyone would agree that relying on widely differing national legislations in this crucial area is the best recipe for preventing optimal financial integration in the European Union.

Second, the legislative process is also far too rigid – by which I mean that existing Directives (or Regulations) cannot be swiftly adjusted to evolving market conditions. Every change, however minor or technical, requires a full-blown Commission proposal to go through the complexities of the lengthy and creaking co-decision process. Yet we all know that one of the dominant features of our global financial system is an accelerating pace of change. Innovation produces almost daily new products and operating techniques ; and under the combined impact of deregulation and competition nothing can be taken for granted in terms of financial structures and practices. The fact is quite simply that we have a decision-making and implementation process in the area of securities markets regulation which is quite unsuited to a world of fast-moving innovation and market practices. The process needs to be reformed to reflect the current environment of substantial and rapid change.

Third, the current system has produced legislation which is of poor (some would even say appallingly poor) quality. In the course of our hearings and in the written submissions we were given numerous examples of Directives which display a lack of understanding of how financial markets actually work in practice. Moreover, the texts are of legendary ambiguity which, as I have just said, opens the door to inconsistent implementation. There seems to be no co-ordinated effort to eliminate these inconsistencies, and neither is there effective enforcement on the part of the Commission.

All these weaknesses and deficiencies are compounded by a plethora of other complexities, such as clearing and settlement systems that fragment liquidity, increase costs and present a real barrier to financial market development in the European Union. Add on to this differences in legal systems (such as bankruptcy laws), taxation, different cultural approaches to corporate governance and a lack of identified regulatory priorities, and you have a remarkable cocktail of Kafkaesque inefficiency that serves no-one – not consumers, SMEs, large corporations, or governments. It was not within the remit of our Committee to address these additional complexities although we could not prevent ourselves from voicing our concern over some of them. As a result, we focussed our attention on the legislative and regulatory process. But before outlining the core of our proposals I would like to spend some time on trying to identify the reasons for the obvious shortcomings of the current system.

### **Why Does the Current System Work so Poorly?**

It is evidently the case that the current system works very poorly and inefficiently and is in serious need of reform. There are several reasons for this.

1. The first, and arguably the most important reason is that the current system ignores the distinction between *primary* and *secondary* legislation or, more precisely, between core principles approved by the legislator and implementation technicalities defined by the executive or specialised agencies – within the confines of the delegation granted to them by the legislator. Such a distinction exists in practically all our national legislative systems, although the terminology used to make the distinction differs from country to country. In Belgium, for instance, a law voted by the Parliament is implemented *via* an ‘arrêté royal d’exécution’. Because there is no such distinction in European law, the Commission has to draft frighteningly long and exceedingly detailed



Directives, of which every element has to be agreed by the Council and the European Parliament.

The consequences are dramatic. They derive, first, from the fact that the two legislative bodies are prevented from concentrating on what should be their primary task and for which they are qualified: to decide, after careful debate, what are the core political principles – the ‘essential elements’ – of each Directive or Regulation. These basic principles are lost in the swamp of details and technicalities. Second, the Commission itself is drawn into drafting such details without possessing the expertise for efficiently carrying out this task.

May I come back for a minute to the story of the unfortunate cross border take-over Directive? This Directive has now got stuck because – after almost twelve years – it appeared that the European Parliament (under the leadership of its German members) wanted to retain the right of the management of a targeted company to reject a hostile take-over bid without consulting its shareholders (for instance, by using the ‘poison pill’ defence tactic). The question of whether or not the ultimate decision lies with the shareholders is very much a matter of ‘core principle’. Had this issue, together with the other core principles, been put squarely to the two legislative bodies right at the beginning of the legislative process, the conflict would have emerged with clarity from the outset. Although it would not necessarily have been solved with ease, at least the legislators would have had to assume their political responsibility for making their choice between conflicting principles at the outset – not after a decade of haggling. In other words, a clearer focus on ‘core principles’ at the outset of the process would enable disputes to be identified early on, and the nature of the important decisions would be transparent at the beginning of the process. We need to make a clearer distinction between *primary* and *secondary* legislation because the present lack of a clear distinction provides an optimum breeding ground for poor legislation, confusion and a slow legislative process.

It also bears the major responsibility for the rigidity of the system. Speedy adjustment to the evolving financial scene means adjustment of the implementation technicalities – not of the core principles. But none of the three institutions is qualified to handle this adjustment within the present system. The Commission is far too removed from the practicalities of the market place to be able to detect the need for a change; and even if it happened to make the right proposal at the right

time, the two legislative bodies would be ill-equipped to pass judgement on the appropriateness of the proposal.

2. The second reason for the shortcomings of the current system is its basically 'top down' approach. The initiative to legislate is taken by the Commission whenever it considers, from a broad European angle, that there is a need to legislate and that there is a constitutional basis for doing so. The proposal it makes is then debated by government representatives – officials from finance ministries – and Euro MPs, mostly the active members of the European Parliament's Economic and Monetary Affairs Committee.

I have no doubt that when core principles are at stake representatives of the three institutions must play their full role, as I have argued just a few minutes ago. That is their right and duty. But even here I feel that they should make ample use of advice coming from 'below', i.e. from practitioners close to the realities of the market – be they regulators or market participants. To set in motion a legislative process requires information: on the pros and cons of legislating at all at the European level; on the main elements of such legislation; and on the guiding principles. And when the debate starts on a draft from the Commission, both legislative bodies would be well advised to listen to the reactions of all the interested parties. This consultation process is important because it should at least minimise the risk of making serious errors, and should alert the law-makers to some of the likely consequences of their rules and legislation. This does not, of course, mean that the law-maker should respond to all the comments made: indeed, that would be impossible given their sometimes contradictory nature. It does, however, mean that law-makers should have access to informed comment. This means that there would be advantage in having explicit mechanisms for public consultation.

When it comes to secondary legislation, the deficiencies of the 'top down' approach become even more obvious. The very nature of implementing technicalities, and their timely adjustment to changing market circumstances, requires a type of organisation in which those capable of giving advice should be entitled to take the initiative. By doing this, 'top down' would begin to closely resemble 'bottom up'.

The information gathered from our hearings, and also from the written submissions we received, suggests that consultation has so far been

inadequate. In most instances market participants have been offered the opportunity to make their voice heard only after the publication of a draft proposal. Moreover, only very rarely does such consultation turn into a genuinely interactive dialogue.

3. The current legislative process is remarkably opaque. This does not apply to the part played by the European Parliament, which deserves praise for practising full transparency. But it does apply to the role of the Commission and even more to the activities of the Council. This lack of transparency has two deplorable consequences.

One is that, even when there is consultation, this cannot yield optimal results: for how can the consulted practitioners form an operationally useful view on matters under discussion when they do not know how the discussion is progressing among member states and inside the Commission as well as between the Council and the Commission? And how can they defend what they perceive to be their legitimate interest without knowing who defends what argument? Consultation and transparency are twin requirements. Genuine consultation requires transparency; but how can there be transparency if there is no consultation?

Second, the lack of transparency has a debilitating effect on the quality of the legislative process. It encourages behind-the-scene compromises in which participants in the decision-making process accept a deal in the hope of deriving a benefit from a reciprocal concession in a field totally unrelated to the working of securities markets. Politics (or simply human nature) being what they are, it would be unrealistic to hope that such across-the-border concessions could be eliminated, but it is worth trying to reduce their frequency. Transparency can contribute to achieving this objective.

### **The Main Components of our Regulatory Reform Proposal**

The Committee believes there is a need for all financial services and securities legislation to be based on a conceptual framework of overarching principles. The most important could be:

- to maintain confidence in European securities markets;
- to maintain high levels of prudential supervision;
- to contribute to the efforts of macro and micro prudential supervisors to ensure systemic stability;

- to ensure appropriate levels of consumer protection proportionate to the different degrees of risk involved;
- to respect the subsidiary principles of the Treaty;
- to promote competition and ensure that the Community's competition rules are fully respected;
- to ensure that regulation is efficient as well as encouraging, not discouraging, innovation;
- to take account of the European, as well as the wider international dimension of securities markets.

The core of our proposal centres around a four level approach to the regulation of European Securities markets.

The Level 1 legislative acts should concentrate on the core political principles: the 'essential elements' of each Directive or Regulation. The Council and the European Parliament, acting on a proposal from the Commission, would agree on the key political Directive and orientation for each subject. Most important, the Council and the European Parliament would agree on the nature and the extent of the implementing measures to be decided at the second level. The split between Level 1 framework principles and Level 2 implementing measures will have to be determined on a case-by-case basis.

Let me emphasise again how important I believe it is that the Commission should consult, in a very open, transparent and systematic way, before making its Level 1 proposal. With this in mind, Annex 2 below outlines the consultation and transparency mechanisms for Level 1 as contained in the Committee's final report.

Level 2 is composed of an actively functioning network of national securities regulators, the Commission and a European Securities Committee to define, propose and decide on the implementing details of framework Directives and Regulations which have been determined by the co-decision procedure in Level 1.

This implies the setting up of two new committees:

- An *EU Securities Committee* (ESC) whose central role would be to act as a regulatory committee under Article 202 of the Treaty, in which the Commission's proposal would be voted on with a short, fixed deadline. The Member states should nominate members to the ESC, which the Commission would chair.
- An *EU Securities Regulators Committee* (ESRC) which in Level 2 would act as an advisory committee to the European Commission. Its members

should be the heads of the competent national authorities for securities regulation designated by each Member state – building on the structure already successfully established by FESCO.

The role of the *ESC* would be to:

- act as a Regulatory Committee where the Commission's proposal would be voted within a fixed deadline of 3 months;
- act in an advisory capacity to the Commission for the Level 1 legislation;
- advise the Commission on Level 2 mandates for the ESRC.

The membership of ESC has to be at a high level. Collegiality and 'esprit de corps' are considered as very important. The role of the *ESRC* would be twofold:

- in Level 2, to be an independent advisory group to the Commission;
- in Level 3, to act as a fully independent committee of national regulators to ensure a more consistent implementation of Community Law.

The ESRC must be composed of national regulators. Four basic procedures must be followed for ESRC consultation:

- consultation on the basis of a concept release (3 months);
- consultation with markets and end-users on the basis of a draft proposal (3 months);
- hearings, roundtables, internet;
- public comments should be appended to each of the ESRC's final recommendations.

The working method in Level 2 could be summed up as follows. In the light of the Level 1 co-decision process, the Commission would ask the ESRC to begin work on the implementation details and agree a timeframe for the work to be carried out. After having consulted market participants, the ESRC would forward its advice to the Commission, which would consider this advice and forward its proposal to the ESC, which would then vote on the proposal.

I would like to insist on three important points made in our Report:

- The European Parliament must be kept fully informed throughout the process, in line with inter-institutional agreements;
- The consultations carried out by the ESRC should be open, transparent and inter-active; Annexe 3 below outlines the Committee's proposals for the consultation process with respect to the ESRC;
- Both the ESC and ESRC must be high level committees.

In order to maintain institutional balance and involvement of the European Parliament it is proposed:

- to keep the European Parliament fully informed;
- to give the European Parliament time to check the proposal before ESC votes;
- to ensure that the Commission takes utmost account of any European Parliament resolution against the proposal;
- to give an adequate role to the European Parliament.

Now let me come to Level 3 in which the Levels 1 and 2 European legislation is transposed and implemented in the Member states. At this stage the ESRC puts on a different hat: it acts no longer as an adviser to the Commission, but assumes the more 'independent' role of ensuring consistent transposition and implementation. The fact that the ESRC plays a key role in the process of defining the Level 2 component of the Directives is likely to go a long way towards ensuring that it can be an efficient co-ordinator of the transposition process.

In *Level 3* the objective is to improve day-to-day transposition and implementation. ESRC is more independent and voting by unanimity is necessary. The role of the ESRC is:

- to produce consistent guidelines for administrative regulations;
- to issue joint interpretative recommendations and common standards;
- to compare and review regulatory practices;
- to carry out peer reviews.

An important and immediate condition of the ESRC to be able to perform its dual role is that those mandated by the national regulatory authorities should have both the knowledge to carry out their work and the ability to deliver from the very outset the undertakings on which they have agreed. In the longer run, a more fundamental convergence is necessary among European regulatory structures – for the simple reason that differences in these structures make it cumbersome for the national authorities to co-operate within the ESRC. At the moment there are several important differences in these structures: the areas covered; the degree of autonomy of regulators; and not least the way in which market participants are involved in the regulatory process. These issues need to be addressed.

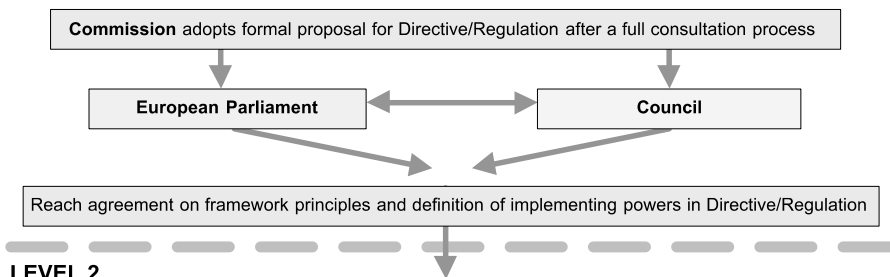
Level 4 is that of enforcement. We propose to strengthen the enforcement of Community rules. All actors have a part to play here, but the major

responsibility falls on the Commission, which has the legal duty to act as guardian of the European treaties.

This four-level approach is represented by a chart taken over from our Report, and reproduced below.

# THE FOUR-LEVEL APPROACH RECOMMENDED BY THE COMMITTEE

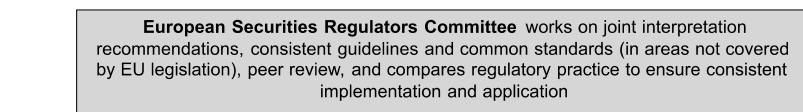
## LEVEL 1



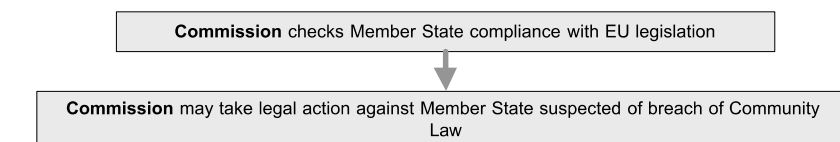
## LEVEL 2



## LEVEL 3



## LEVEL 4





## Queries and Objections

After its release on 15 February, our Report received a broadly positive welcome. However, there have been quite a few queries and some objections have been raised. Let me try to respond to three of the major concerns that have emerged:

1. The proposed framework is far too complex – especially as regards the interaction between the Commission, the ESC and the ESRC.

To some extent the complexity of our design is more apparent than real. In writing our final report we responded to ECOFIN's request to 'clarify and refine' the regulatory framework suggested in our initial report and 'propose operational recommendations'. Describing in some detail the operation of any system is bound to appear complicated, even if the operation can in fact be quite simple. A manual summing up instructions of how to ride a bicycle may look frighteningly complex, yet five-year-olds can be expert bicycle riders.

At the same time I do not deny that, in some respects, our proposed reform is not simple. But there are reasons for this. We are not dealing here with some broad guidelines governing gentlemen's agreements but with a legislative process. Any such process requires careful and precise description, and has to find its place in an existing legal environment. Moreover, this is European law-making; and whether we like it or not, the European Union is a highly complex organisation.

2. Why does the Report refrain from recommending the setting up of a single European securities regulator?

The Report refrained from recommending it in the present circumstances, for two good reasons. First, because no such regulator could operate today without the gaping holes in the European financial legislation being filled-in in the first place. It is conceivable that a single regulator would be endowed with the authority to interpret core principles or to define Level 2 implementation technicalities, but it is unthinkable that it could become a legislator deciding on Level 1 framework principles.

The second reason is that setting up a single European regulator would require a new Treaty (in the same way as the European Central Bank

could not have been set up without the Maastricht Treaty). The negotiation, drafting and ratification of a new Treaty would take several years – yet the reform of the current system is of the utmost urgency. Without such a reform the implementation of the Financial Services Action plan cannot be completed by 2004, and even less brought forward, partly at least, to 2003. We saw no alternative to submitting reform proposals within the confines of the existing Treaty.

Some might object that this need not have prevented our Committee from outlining the profile of a potential single regulator. This would have been in line with the very last sentence of our Report which says that ‘if the full review were to confirm in 2004 (or earlier as the case may be) that the approach did not have any prospect of success, 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’. We did not volunteer to outline any such profile. This would have required a careful and very thorough analysis for which we simply had no time. I also believe that such an exercise, however carefully qualified by liberally using ‘if’ and ‘when’, would have derailed the constructive discussion of our reform proposal.

3. Why should the proposed regulatory framework be able to function properly when success hinges on the change of behaviour of the very same actors – Commission, Council, European Parliament – who bear a shared responsibility for the shortcomings of the present system?

It is recognised that simply changing institutional structures does not in itself guarantee the right policies. In the final analysis, it is what regulators, legislators, etc. do that is important rather than which agencies do it. So I accept that this question is, indeed, a major concern which should not be dismissed lightly. Hence our repeated insistence throughout our Report to:

- give a clear mandate to the two key Level 2 committees;
- ensure full transparency of the system, coupled with deadlines in the decision making bodies;
- throughout the whole legislative process to consult regularly with market participants and consumers;
- implement strong monitoring and reporting to the Council, Commission and Parliament, and to the public at large.

### **Developments Since the Release of the Report**

In its Resolution on 23 March 2001, the European Council endorsed the essential features of our proposal, including our call for a ‘full an open review in 2004’, and requested that the new regulatory structure should be operational from the beginning of 2002 at the latest.

On one specific point, however, the Resolution did not follow our recommendation. We suggested that the Securities Committee (ESC) should vote by qualified majority on proposals coming from the Commission, and that the votes should be weighted in the manner set out in the Treaty for the votes in Council. This implied that it would be highly unlikely that a proposal emanating from the Commission and based on the advice received from the ESRC would be rejected by the ESC. In my discussions with Euro MPs I argued that this would demonstrate the willingness of governments to grant concessions in order to make the proposed system effectively operational.

In Stockholm, however, the Commission watered down our proposal regarding the voting procedure, mainly under pressure from the German government. As a result, in its resolution the European Council noted that ‘the Commission has committed itself, in order to find a balanced solution for those cases of implementing measures in the field of securities markets acknowledged in the light of discussions to be particularly sensitive, to avoid going against predominant views which might emerge within the Council, as to the appropriateness of such measures’. What are ‘predominant views’? It presumably means less than qualified majority, since otherwise there would have been no reason for asking the Commission to make this commitment. Does it therefore mean a simple majority? Or the views of one or several ‘predominant’ countries? And how will the interested investors, issuers and market participants learn about the emergence of such views?

This departure from our original proposal has not created a healthy climate for finding a solution to the Parliament’s request to be granted a ‘call-back’ or ‘parliamentary override’ provision relating to the Level 2 measures. We were persuaded by the legal advice we received that a formal call-back provision would be incompatible with the current institutional arrangements. I believe, on the other hand, that if our Committee’s recommendations are properly implemented, the Parliament will be able to have a significant impact on the Level 2 decision-making process. Let me spell out (as we did in our report) what should be the three main features, in this respect, of a ‘proper’ implementation:

- full transparency at all times;
- sufficient time for the Parliament to check that the decisions are in line with the scope of the implementing measures it agreed to;
- if the Parliament believes that the Commission is exceeding its implementing powers it should be able to pass a resolution. Were it to do so, the Commission would be required to re-examine its proposal and should take the utmost account of the Parliament's position. It would be inconceivable if it did not.

Acceptance of these recommendations would give the Parliament – *de facto* though admittedly not *de jure* – something that comes very close to a parliamentary override. For we should keep in mind that Level 2 decisions are to be decided on a case-by-case basis. This means that if the Parliament were dissatisfied with the Commission's reaction, the consequences would be felt next time a request for Level 2 implementing powers were made.

Given the importance of reform of securities markets regulation, my own wish (and hope) is that the proposed framework is given a fair chance to function during the next two years which are so crucial for the implementation of the Financial Services Action Plan. This implies that the Parliament does effectively play the delegation game at the same time as governments refrain in practice from reminding the Commission that it has accepted the 'predominant views' concession. For the rest, the commitment to undertake a 'full and open review' in 2004 should be interpreted to imply the willingness to address with an open mind whatever concerns may have remained in the minds of Euro MPs regarding the functioning of the new system. Most importantly, it should also imply that consideration will be given to the formal introduction of a two-level legislative procedure.

### **Concluding Remarks**

I have noted that our legislative and regulatory approach has been received with interest, well beyond the world of finance, by all those who find the present system of governance in the European Union unsatisfactory. I am not qualified to argue that our approach should be extended to other areas of European legislation and regulation – for the simple reason that the approach which we proposed is not the result of putting into practice pre-conceived ideas about the generally desirable features of European governance. Rather, it emerged – admittedly quickly – from the observation that in the specific field of financial services the current system was working very poorly indeed. The impression of dysfunction in this field has however been so strong and

the identified shortcomings – no distinction between *primary* and *secondary* legislation, ‘top down’ procedures, lack of transparency and consultation – so blatant that the prevalence of similar weaknesses seems to me likely to be widespread. Whether this is true or not should, however, be checked by looking into the working of the legislative and regulatory practices in other areas as well. The debate about the global reform of governance in the European Union badly needs the support of empirical evidence.

This is the more so since the balance of power between the three institutional poles – Council, Commission, Parliament – is in a state of flux. Part of these uncertainties is understandable and probably unavoidable, given the unique features of the European integration process. But with 2004 on the horizon, these uncertainties are now reaching a degree that can become genuinely detrimental to any legislative and regulatory initiative. The possibility, indeed the likelihood, of changes in the balance of power induces defensive reactions on the part of all three institutions. Whatever deal is made today can serve as a precedent for more systematic changes in 2004. This is vividly illustrated by the fact that the European Council resolution on the Commission’s commitment regarding the ‘predominant views’ goes on to say that ‘this commitment shall not constitute a precedent’ – while we all know that the commitment itself was requested on the basis of a former precedent (the so-called ‘aerosol’ clause).

Again, we cannot hope to eradicate these defensive reactions; but their deleterious consequences could perhaps be limited by introducing more factual evidence into the important debate on governance. And again, I emphasise the need for active consultation at all stages.

## **ANNEX 1**

### **Analysis of the Comments on the Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets**

#### **Summary**

Forty one replies have been received, most of them from the private sector.

All the respondents welcome the general thrust of the Committee's initial report. They consider it as a valuable contribution to the policy debate. They all share the analysis of the current situation contained in Chapters I, II and III of the initial report. They also share the view that urgent steps must be adopted in order to remove barriers to the integration of the European financial market.

Most of the replies focus on the possible approach for European Regulation described in Chapter IV of the initial report.

There is a general agreement that a more efficient, flexible and faster legislative process is needed. Responses nevertheless insist that faster legislation should not be at the expense of the quality of the regulatory system.

Respondents also support the main lines of the proposed institutional and regulatory framework. However the objectives have to be defined. The distinction between primary and secondary technical legislation needs to be delineated clearly. Political willingness will be necessary to achieve this objective.

Most of the respondents called for a more detailed analysis of the regulatory approach with practical examples in the final report.

The main issues raised by the respondents:

## 1. Guiding principles for the new regulatory framework

Most of the respondents consider that the following principles need to be applied:

- Transparency of the whole legislative process is seen as fundamental. This implies early publication of preliminary thinking about policy, open consultation methods, the publication of agendas, the publication of minutes and documents of meetings, the establishment of forum/technical groups, organisation of conferences, roundtables, etc. The European Institutions and the new regulatory model should therefore adopt these working methods. Respondents also called for the Securities and Regulators Committees to set out these principles as a rule.
- Openness. Market practitioners and consumers should be involved in the legislative process through early and continuous consultation.
- Accountability. The democratic accountability of the Securities and Regulators Committees is seen as of vital importance. Respondents stated there must be adequate accountability mechanisms to fully inform the European Parliament. Different variants were suggested, such as hearings in front of the Parliament, regular reporting and the granting of observer status to the European Parliament in the Securities Committee.

**Table 1: Comments on the New Approach Set out in the Initial Report**

<b>General opinion on the initial report</b>	Full support of all respondents
<b>Role of regulation/level of regulation</b>	Need for a balance; avoid over-regulation
<b>Guiding principles</b>	Transparency, openness, accountability and flexibility
<b>New approach of the legislative system</b> → Level 1 → Level 2 → Level 3 → Level 4	Widespread support for the concept of a four-level system  Need for a clear definition of basic objectives  Need for a clear distinction between primary and secondary legislation
<b>Regulations/Directives</b>	No clear positions expressed
<b>Role of national regulators</b>	Need for harmonization of competences General support for increased co-operation
<b>Transparency</b>	Needs to be set out as a guiding principle
<b>Role of market participants /consumers</b>	Early and institutionalised involvement in the legislative process
<b>Enforcement</b>	Need for increased resources for the Commission

## 2. Possible four-level approach

A small number of respondents argued that the adoption of a set of principles and objectives applying to all securities legislation would be useful for assessing future legislation.

### (a) Level 1

The adoption of Level 1 legislation is considered to be crucial to the success of the new approach. A clear distinction must therefore be drawn between primary and secondary legislation (principles in Level 1, implementing details in Level 2). This may vary depending on the subject. Level 1 should contain „essential elements“: fundamental principles which are unlikely to require amendment in the short or the medium term.

On the type of legislation, the suggestion to move from Directives to Regulations was also mentioned. Nevertheless, respondents did not set out clear preferences for either.

### (b) Level 2

The final report should expand on some of the key points, such as:

- The role, the objectives and the working procedures of both Committees  
There is a general consensus that a set of objectives should be drafted to define the competence of both Committees. The need for transparency and co-operation with market-practitioners should guide their work and deliberations. Several respondents expressed concerns about transposing FESCO's working methods to the EU institutional framework. They therefore called for more details on the working procedures of the Regulators Committee.
- The composition of the Regulators Committee  
As there is not a common template for supervision, the composition of the Regulators Committee raises major issues, and some concerns. For example, the Competent Authorities that should advise the Commission in Level 2 might be current FESCO members. The missions and competence of national regulators vary considerably among the Member States. Prior harmonization of the national regulatory functions would therefore be desirable.



- The links between the Securities and the Regulators Committees and the European Parliament (EMAC)

The respondents called for the role of the European Parliament to be respected in order to keep the legislative process open, accountable and democratic. Different models are proposed, such as the full accountability to Parliament of the Securities Committee, and the obligation to regularly report the activities of the Committees.

**Table 2: Comments on the New Institutional Framework**

<b>Securities Committee</b>	General support for its establishment. It needs to be accessible and transparent
<b>Regulators Committee</b>	Demand for more details on its role and composition
<b>Role of European Parliament</b>	Its rights should be preserved. Accountability of the Securities Committee to it is recommended
<b>Links between both Committees</b>	More details are requested
<b>Comments on FESCO</b>	Criticism on the lack of transparency
<b>Single European Supervisor</b>	General agreement that it would be premature to create it for the time being

**(c) Level 3**

Most respondents consider that differences in the competences and powers of national supervisory authorities hinder the consistent application of EU legislation and effective international co-operation. A great majority of replies indicate that prior harmonization of the national regulators competences is seen as necessary, as well as a thorough revision of the division of responsibilities between supervisory authorities and exchanges.

**(d) Level 4**

The lack of enforcement by the Commission is seen as having been a serious obstacle to the completion of a single market for financial services. Proposals for an increase in the enforcement resources and instruments for the Commission should be considered in the final report.

**3. Other comments**

Respondents have also submitted comments on the other preliminary conclusions of the initial report.

These are summarized in the following table:

**Table 3: Other Comments on the Preliminary Conclusions**

<b>Economic benefits</b>	Agreement on the proposal to carry out a proper study of the benefits
<b>Trade issues</b>	Endorsement of the Wise Men's analysis and suggestion to address these issues more prominently in the final report
<b>Market volatility</b>	Suggestions to exclude any assessment of volatility from the final report
<b>The FSAP</b>	General agreement to accelerate the completion of the FSAP to 2004. The EU needs to ensure that faster legislation does not mean lower quality legislation

Some additional comments deal with the main technical issues contained in the initial report.

These are summarized in the table below:

**Table 4: Additional Comments**

<b>Clearing and Settlement</b>	Suggestions to remove the obstacles necessary for the completion of a European market. Others express some doubts concerning the initial report's assessment of the savings that could be generated by an integrated clearing and settlement system. Some raise competition questions. Most of the respondents consider that market forces should drive the consolidation process.
<b>Country of origin and mutual recognition</b>	Some replies insist on the immediate and widespread implementation of these principles, notably for wholesale markets
<b>Alternative trading systems</b>	Request for the establishment of a level playing field between the exchanges
<b>OTC market</b>	Further regulation of the OTC markets considered unnecessary and undesirable
<b>Categorization of investors</b>	Differentiation between investors generally considered useful and necessary



## ANNEX 2

### Level 1 Consultation and Transparency mechanisms

The European Commission alone has the right of initiative under the Treaty. However the Committee recommends that in the future, before the Commission draws up a proposal in these areas, it should take the following steps:<sup>1</sup>

1. Consult, beforehand, in an open, transparent and systematic way with market participants and end-users (issuers and consumers). Deadlines should be set and made clear. Where necessary, open hearings should be held. There should be a strengthened and open dialogue with market participants and end-users so as to advise the Commission on a continuous basis on Level 1 work. Use of the Internet should be used to encourage more participation. A summary of the consultation process undertaken should be made available when the final proposal is made. The Committee recognizes that this will take a little time to set up and that there are resource implications for the Commission services.
2. Continue to consult Member States and their regulators on an informal basis as early as possible on any impending Level 1 proposals.
3. Inform the European Parliament on an informal basis of forthcoming proposals (including more systematic use of the „2005“ group)<sup>2</sup> and seek, wherever possible, early, non-binding, understandings on the scope of any implementing powers that might be delegated to Level 2. This will help guide the European Commission, the Regulators and Securities Committees on the scope of the work that they should undertake, preparing them, where possible, in advance of any formal co-decision agreement in order to gain time.

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<sup>1</sup> See, inter alia, paragraph 9 of the Protocol, on the application of principles of subsidiarity and proportionality annexed to the Treaty of Amsterdam (O.J. C340, 10/11/1997, p. 0105)

<sup>2</sup> The „2005 Group“ is an informal high level group composed of the chairperson of European and Monetary Affairs Committee of the European Parliament; the Presidency of the Council of Ministers, the incoming Presidency and the European Commission.



## ANNEX 3

### Consultation procedures and transparency

The Committee considers that the ESRC must consult market participants, consumers and end-users according to a fixed, preferably mandatory set of procedural rules that should be set out in its statutes and rules of procedure. The following principles should apply to the consultation process:

- market practitioners must be involved .
- at every level ...
- in a continuous process ...
- with particular weight given to those with knowledge and expertise on the subject in question ...
- in an open process, using, *inter alia*, the Internet ...
- with end-users views being considered at the same time.

The Committee considered the merit of „*practitioner forums*“ at European level, but given the complexity of deciding who should be members, bearing in mind that there are 15 Member States (and soon more) as well as a wide range of interests to be covered, the Committee prefers the alternative outlined below.

Once advice on implementing measures has been requested from the European Commission, and with a specified timeframe agreed for the work, the ESRC would set up the consultation process.

Four basic procedures could be envisaged:

- In the case of complex issues, the ESRC should consult first on the basis of a „*concept release*“ – outlining the problem and the options and asking for public input on what, if any, regulatory approach would be appropriate. The time for such a consultation should not exceed 3 months.
- Once a regulatory approach had been decided, a draft proposal would be released by the ESRC for consultation with markets and end users (3 months maximum).

- Where necessary the ESRC could use hearings, or roundtables, as this Committee has done. Use of the Internet should be compulsory for the consultation process.
- A summary of the public comments should be appended to each of the ESRC's final recommendations.

The Committee recommends the Commission to maintain a similar level of transparency and openness as these proposals move to the Securities Committee.

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  - 2) Peter H. Haiss and Gerhard Fink, **Seven Years of Financial Market Reform in Central Europe**
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13. Martin M.G. Fase, **Investment in Paintings: The interaction of monetary return and psychic income**, Vienna, 2001, ISBN 3-902109-05-X.