EC finance rules face fresh obstacles

Getting European nations to agree on a set of financial services rules was hard work. Community directives can be vague, providing fertile ground for more disputes. By Richard Bacon

The European Community's main financial services directives are almost in place but putting them into practice promises to generate a host of fresh problems. The single-market schedule for investment firms is three years behind most sectors, including banks, because of battles over capital-adequacy requirements and the rules for operating an investment business which has a single passport.

The definitive text of the capital adequacy directive (CAD) was agreed by the EC council of ministers in March. The investment services directive (ISD), which provides the single passport for investment firms, should follow early this summer. Both directives come into effect on January 1 1996. Between now and then the parliaments of the EC member states must turn the directives into national laws. "The devil will be in the implementation," says a former official at the council of ministers.

When first published, the rules on capital adequacy alarmed securities houses. The proposals provoked fierce discussion, with dire predictions of securities firms being hammered by the universal banks and of business fleeing to Switzerland.

Fears of super-equivalence

There is little doubt that London-based independent securities houses prefer the Securities and Futures Authority rules. But officials at a number of independent securities houses admit that they can live with the CAD rules which have emerged. The requirements for equity position risk are tougher than many would like, but one Brussels lawyer who advises several large US securities firms says: "The people we deal with, including a couple who specialize in equity, do not view CAD as a disaster." Susumu Takiguchi, director of strategic planning and research at Nomura Europe, is cautiously optimistic: "I think in the end the London-based houses are probably in a good position," he says.

The main fear now is of so-called super-equivalence – that some domestic authorities will insist on significantly tougher capital requirements than the CAD minimum. The rules on capital are the responsibility of the

The men who run the directorate

Richard Bacon puts names and faces to the bureaucrats in charge of regulating Europe's financial services.

'Nice chap' with a banking background

Jose Maria Fombellida Prieto is an engaging, cigar-chomping Spaniard who studied law in Spain and politics in Paris before becoming an international banker, for "several French, Spanish and Arab banks in east Asia, the Middle East, Latin America, in Paris and in Madrid". After 16 years as a practitioner, he was appointed adviser to the Spanish Institute of Foreign Trade. When Spain joined the EC he was among the Spanish quota of civil servants who came to the commission, where he heads the stock exchanges and securities division. Industry sources do not suggest that Fombellida is driven by an insatiable work ethic. "He is a very nice chap," says one former official at the council of ministers.

The high-flying Dutchman

Humbert Drabbe entered the EC affairs department of the Dutch foreign ministry after reading for a degree in public law. He moved to the Dutch treasury, from where he was seconded to the Organization for Economic Co-operation and Development in Paris for four years. He speaks English with an astonishing British accent – "more British than the British", says one insurance industry source. In 1987 Drabbe returned to the Dutch treasury where he became head of insurance, and moved to Brussels in 1989 to head DGXV's insurance division. The extraordinary speed of progress on the insurance industry directives is attributed in no small measure to his skill and that of his erstwhile deputy, Jean-Jacques Marette. "Both were absolutely brilliant," says one insider.

There almost from the beginning

Paolo Clarotti was there when the commission started negotiating the Dillon round of the General Agreement on Tariffs and Trade. He founded the division that did it, and then led negotiations on the subsequent Kennedy round. "He knows an awful lot because he has been around for a very, very long time," says one banker. Born in Italy, Clarotti studied in Paris, taking degrees in law and economics. After a few years working in Milan "in the field of trade" he joined the embryonic European Commission in early 1959, where he has been ever since. Clarotti headed the insurance division for seven years and then in 1972 was appointed to head the banking division, which he "practically started from scratch". One lobbyist describes him as "relatively inflexible". All the harmonization measures for the single market in banking have been achieved under his stewardship. Parts of the second banking directive stem from proposals he launched in the early 1970s. "It has taken some time," he says.. Clarotti is soon to become adviser to DGXV's new director-general. One source says: "He'll just carry on doing what he's always done, which is swanning aroung Europe talking about directives and going to conferences."

Fombellida: engaging.

Drabbe: "absolutely brilliant".

PHOTOGRAPHS BY JÉRÔME DE PERLINGHI

home member state, so using its single passport a continental firm with a less stringent regime at home would be able to come to London and clean up. "We will want to ensure that German banks operating in London have the same requirements in London that we do," says a compliance officer at one major US brokerage house. A source at the British Merchant Banking and Securities Houses Association suggests that "providing the UK implements the CAD flexibly – and there are signs that it wants to do that – then there is no problem".

The minimum capital standards laid down in the CAD are the price of the single passport. But even if the ISD is smoothly implemented, there are other hurdles in the way of an effective single market.

One potential minefield is a provision in the ISD for host member states to prevent or penalize irregularities committed in their territories. These may be actions which are contrary to legal or regulatory provisions "adopted in the interest of the general good". If member states consider that their rules have been infringed, article 19 allows them to prevent offending investment firms "from initiating any further transactions in their territories". Peter Troberg, the official responsible for implementation at the EC's directorate-general XV (DGXV) which handles financial services, concedes: "That's perhaps the area where cases will come to the court rather frequently."

The biggest danger lies in differing tax treatments of financial products

The concept of "the general good" is found in much community legislation. It is usually inserted at the insistence of the member states, for whom it is a potential let-out clause from unpalatable aspects of agreements they have reached. In the financial area, the fear is that member states will exploit the provision on general good in the ISD to defend local businesses against incoming competition.

"We should always be clear about one thing," says Troberg. "The principle is freedom, 'general good' is the exception. And being an exception, it must be interpreted in a narrow way." Troberg may have an ally in the European Court of Justice, the ultimate interpreter of EC law. The court has recognized that certain measures may be justified in the interest of the general good but has tended to interpret such clauses strictly.

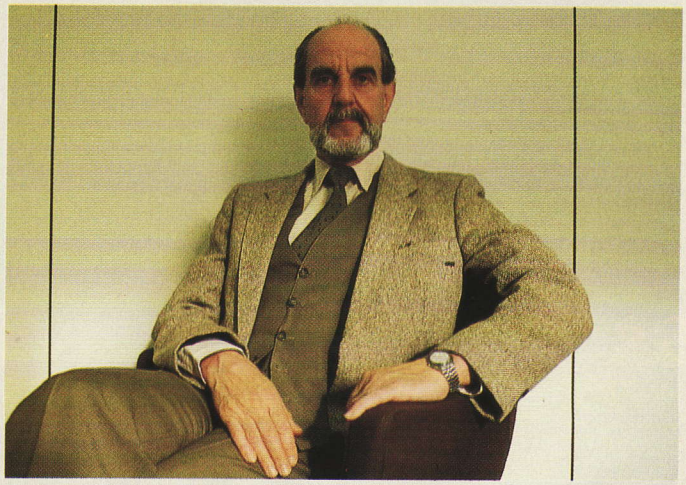
The biggest danger lies in differing tax treatments of financial products. Member states jealously guard their rights on tax policy. Attempts to achieve wider co-ordination of the tax laws could be politically explosive. The court is sensitive to this risk and has been unwilling to find that it contravenes EC law for a tax system to discriminate against financial products supplied by foreign firms. Instead, the court has accepted that the coherence of a fiscal system is a general good. "The major stumbling block will be fiscal," says Troberg.

Vague principles

It will not be the only problem. Under the single passport approach, an investment business seeking to operate anywhere in the community will need authorization only from its home member state. But host countries ▶

Grand concepts, fine detail

"Jean-Pierre Fevre sometimes talks like a Frenchman, in grand conceptual schemes, and sometimes like a supervisor, in mind-boggling detail about things that you don't understand. He knows his stuff backwards." So says one impressed Whitehall official. In the view of an EC central banker, he is "possibly one of the few people in the commission who actually knows what a financial service is". Fevre graduated in management "many years ago" and joined the Banque de France, latterly spending 15 years in banking supervison. As head of the French Banking Commission, he led the national team on the negotiations for the second banking directive. In 1989 he became director for financial institutions in DGXV. "He's very good at not being too Trojan-horsish," says a British source. "There was a lot of aggravation from the French on the ISD over stockmarket organization, and he didn't get sucked in by the national line." One French banker warns: "If you invite him to a restaurant make sure you choose a quiet corner or you won't be able to hear what he says."



Troberg will need all his professionalism to implement the rules.

Fevre: one of the few in the EC who know what a financial service is.

A well-versed professional

Peter Troberg is a man with a mission. The major financial services directives may now be virtually in place but a big assignment remains: implementation.

A myriad of problems could arise, but as the DGXV official responsible for implementation, it is Troberg's job to smooth the path.

"He is a very sensible man," says a US lawyer with an interest in EC regulation. "Really quite sound" is the verdict of one former official at the council of ministers.

An American banker who has had extensive dealings with DGXV says: "He is very professional and extremely well-versed in the different directives."

Troberg will need all these qualities for the task ahead. He recognizes the difficulties that threaten to prevent putting the rules into practice.

Use of the courts has not been ruled out. "It can be done discreetly," says Troberg. But any decision to invoke the law will not be his: that responsibility rests with the commissioners and their right-hand men.

An august presence at the heart of Europe

The new European commissioner for financial institutions and the internal market is tall, slim, august in manner, with a magnificently aquiline nose. He would look good on a postage stamp. Raniero Vanni d'Archirafi, 61, is a nobleman of Sicilian ancestry, born in Geneva into a family with a tradition of diplomatic service at the Italian court. He is married to an Italian princess. His son is a Citibanker, based in Milan.

Vanni d'Archirafi served as Italy's ambassador to Bonn and Madrid, and was part of the Italian team which negotiated the Maastricht Treaty. His last post was as director-general of political affairs at the Italian foreign ministry. Why has he taken a job which may require a plunge into the minutiae of the building-block approach to capital adequacy?

Danger of technicians

The answer is that he does not think he has. Asked about the split between the trading book and investment book at the heart of the capital adequacy directive, Vanni d'Archirafi reads briefly from an emollient text but casts it aside unfinished.

"There are three ways of being destroyed," he confides. "The quickest is card games. The most pleasant is women. But the surest way is technicians."

He relates his experience as a diplomat in Brussels during the 1960s, where he was assigned to a working group on nuclear affairs. "I was very worried about the difficulties and so I prepared myself very well and studied as I am studying now. At the end of the first meeting, dealing with irradiated material, they asked

Vanni d'Archirafi: "I will not become a banker."

PHOTOGRAPH BY JÉRÔME DE PERLIMGHI

me if I was an engineer or from the Italian nuclear authority." He suggests that the technical-political split is always the same: "I will not become a banker, or a person who is expert in financial services. There are, of course, technical problems, but I am not substituting for the technicians."

So what will he be doing? "I will feel what the main targets are," he says. What does he feel about the SIMs question in Italy? "Before the legislation was introduced, not only Italy had its own approach in its internal legislation," he replies. "There are two stories. One is the existing situation, where we will act according to the existing law. When the directive [ISD] is in place, legislation of some other countries will also have to be changed in specific aspects."

When pressed, he adds: "What is correct is to have a general view about all member countries. We are in a phase of discusssion. If the response is not satisfactory we will go to the European court." But moments later he repeats this sentence with a judicious "may" inserted.

Inauspicious start

Vanni d'Archirafi seems more comfortable talking about the internal market aspects of his job, for which he has many more officials than for financial institutions and company law. But at his first press conference in January, he did not make an auspicious start, calling for an "armistice" on the single market.

He grins ruefully when asked about it and explains that he was referring to the need for a period of observation, to see how the single market was operating. "What I was I was *not* saying was that the transposition of directives should be accompanied by a 'softly, softly' approach. There will be no mercy there to *anybody* because this is the platform on which we build our construction."

It is the construction he enjoys talking about most. The more abstract the topic the more excited he sounds, and his English becomes more Italianate. It sounds quite poetic: "The start of the plenitude of this unique market life..."

must draw up rules of conduct for firms doing business within their territories. These rules must implement a vague set of principles open to various interpretations. One Brussels lawyer says: "It does leave open the possibility that member states will end up with very different rules. In areas such as cold calling and advertizing, it would be very easy for member states who were so minded to create difficulties for new entrants to a market."

There is likely to be confusion about the rules for notification of new cross-border business. The ISD calls for investment firms wishing to exercise their rights under the single passport to notify the home member state authority prior to doing business. But if the service provided is not new, then notification is not necessary. The experience of implementing a similar provision in the second banking directive suggests that defining what constitutes new cross-border business will be problematic. One UK bank has taken the approach of blanket notification for all its businesses.

Authorization required

Under the concentration rules in the ISD, member states may require securities transactions to be carried out on a regulated market. There is an option for investors to avoid this rule but it is for member states to decide how a waiver would operate. Investors could find themselves forced to provide express authorization to a foreign investment firm for every transaction they wished to undertake away from a regulated market.

Even if malign intentions by the member states are entirely discounted, the potential for differences to emerge in implementation is considerable. EC directives can be intentionally vague. Often the result of compromise, they are intended to keep some national discretion intact, setting a framework for legislation. Jean-Pierre Fevre, DGXV's director in charge of financial institutions, says: "Where we have agreed to precision it is mainly because the member states have asked for it."

According to one source involved in the transposition into UK law of the bank accounts directive, the text was so opaque that it was sometimes difficult to find an interpretation that made any sense. This source says: "There was a good deal of tension between the departmental lawyers who were looking at the words and the civil servants who wanted to achieve a practicable solution. Luckily, as well as being badly drafted it had been badly translated, so we were able to exploit discrepancies between the different language texts."

Continental countries with a tradition of Roman law find it easier to implement directives even when they appear vague, and can produce shorter national statutes. Margot Horspool, director of European legal studies at University College, London, says: "Continentals are used to interpreting codes and, if they are not suitable, interpreting things into them that are not there." The system of Anglo-Saxon common law demands

We were able to exploit discrepancies between...the texts

more clarity and this usually means greater length.

With so many potential difficulties, is there any chance that the single market will really work? "Implementation is the genius of the European system," says Ray Calamaro at Winthrop, Stimson in Brussels. "It encourages convergence on general concepts and allows each member state to implement them in a way which makes sense locally. That means the Italians will serve it with pasta, the French with foie gras and the British with fish and chips. But the question is defining the 'it' they are serving it with. If that is as radically different as pasta, foie gras and fish and chips, you've got no 'it'."

Peter Sutherland, former EC commissioner for the internal market, chaired a high level group on implementation last year. The group called for a "permanent framework for administrative partnership" to deal with the application of internal market rules, an admission in Euro-speak that the centre cannot do it alone.

Member states have begun to set up their own consultative groups on implementation, and the commission will call *ad hoc* meetings with government experts from each country to monitor progress. The commission will soon bring forward proposals for a securities committee, with membership drawn from the member states. This will operate in a similar manner to the banking advisory committee set up to monitor progress in banking. The committee is expected to be in operation before the end of the year and will assist the commission in technical alterations to directives. It will also advise the commission on new legislation, and there are review clauses incorporated in the directives on difficult points.

Litigation looms

Implementation of directives will require consultation and flexibility between the member states, but what will be done when one country refuses to implement a provision? The Sutherland group called for a co-operative approach to enforcement but also emphasized close liaison "to provide informal advice on redress to those who request it". If firms find they cannot obtain rights under the single market, they should complain.

Troberg appears keen to know of any problems encountered : "It can be done discreetly," he says. "Cases may be taken up *ex officio*. The commission does not need a ▶

plaintiff and even anonymous complaints could theoretically be followed up."

This applies to the forthcoming rules under the ISD and to existing rights. "A surprising number of complaints are based not on the directives but on treaty principles," says Troberg. Could widespread litigation ruin the concept of the single market? "I would not necessarily see litigation as something negative. Sometimes litigation can extend freedoms."

But the decision to sue is not Troberg's. It is usually made by the *chefs du cabinet* of the EC commissioners, who meet several times a year to review cases. Sensitive issues may be decided by the commissioner. The last commissioner in charge of financial institutions was Sir Leon Brittan, who also held responsibility for competition policy. One US investment banker in London says: "Troberg knew he had authority vested in him by Sir Leon to take a hard line. But it's not clear if he will get the backing now." The cause for concern is Brittan's successor, Raniero Vanni d'Archirafi, who also assumes control of the internal market portfolio.

Sins of the SIMs

Soon after he took over, Vanni d'Archirafi made a speech in which his commitment to vigorous implementation and enforcement of the single market appeared in doubt. He has since explained that he was misunderstood. An early indication of his commitment will be the speed of progress on Italy's SIMs (societa di intermediazione mobiliare).

Italy requires all investment business with Italian counterparties to be conducted through a locally incorporated subsidiary known as a SIM. This requirement, which is plainly a breach of the provisions for freedom of establishment and free provision of services in the Treaty of Rome, was introduced just as drafting of the ISD got under way. It favours banks at the expense of securities firms, because under the second banking directive – the single passport for banks, which came into effect on January 1 – banks can provide investment services throughout the community. Securities firms must wait until 1996 for their single passport. The UK government made a formal complaint to the commission in September 1991.

The commission's preliminary enquiries to Italy were rebuffed. It then consulted an Italian lawyer who specializes in EC law, obtaining a clear legal opinion that the requirement to establish a SIM contravened the Treaty of Rome. Article 169 of the treaty provides that the commission shall then deliver a "reasoned opinion", which warns of potential legal action if the member state does not comply. Italy received this opinion last October and continues to defy the commission. So will the Italians be sued?

"Let us formulate it this way," says Troberg. "We are in the phase between a reasoned opinion and a negative reply, and the next step, which is to go to court." The Italians continue to defend the SIMS law on the grounds of quality of supervision. They argue that the measure is justified since the harmonization of capital requirements foreseen by the single market is not yet in place. They also claim that the equivalent situation exists elsewhere, because central banks throughout the EC insist that primary dealers are locally incorporated.

"The situation is exactly the same," says one official in Italy's Companies and Securities Commission. "It's an old ploy," says a lawyer involved in EC regulatory issues. Government bond markets figure prominently in monetary policy so primary dealerships are a matter of legitimate concern for each member state. Yet on this view, it is arguable that primary dealerships fall outside the scope of the investment services directive. "It is not offensive if central banks insist on these rules for their own government bonds," adds this source, "but it is totally specious to equate primary market-

Lobby early, lobby often

Lobby early, lobby often is the lesson to those likely to be affected by European Community legislation. After tough battles, the main EC legislation for the single market in financial services is almost through. But much of the industry's lobbying on the capital adequacy directive (CAD), the source of a lengthy dispute between the independent securities houses and the continental universal banks, was a model of how not to do it.

Julian Oliver, chairman of the EC committee of the American Chamber of Commerce in Brussels, says that too often the attitude is: "This is Brussels, this is boring, they are only doing framework directives, this won't affect us. They'll have to come to us eventually and ask us how to do it." The drafting of the CAD began in 1989 but many of the London-based firms did not appear in Brussels until 1992. Oliver adds: "When you start that late you have to send the really top people. And even then it is a much harder struggle. Everyone has been antagonized."

Top people do not necessarily help. Another source says: "Visits by elevated persons who are not properly briefed can actually be damaging. If you are lobbying hard on something and a grey eminence floats in and doesn't mention it, the commission will assume it is not that important." Would the commission have liked more input sooner? "It might have saved us some time," says one DGXV official.

"The golden rule is that people should get in much earlier," says Julian Doyle, a partner at the Brussels office of Gouldens. "Get into the general policy mix early on," he advises, "before it all melds together. You must not leave it to the point where you clash." Robert Strivens, a partner at Allen & Overy in Brussels, agrees: "The time to go in is when you first hear the rumour that there is an idea for some draft legislation."

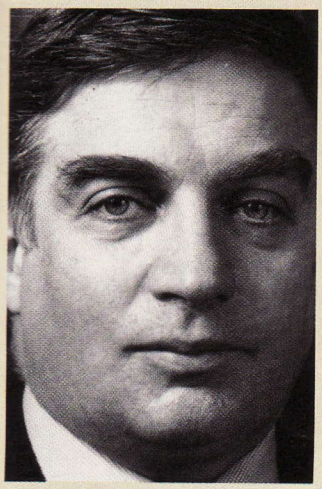
At this stage the commission is often very receptive. Officials may not have developed firm views on how legislation should work and are likely to be looking for information and ideas.

Ray Calamaro, a partner at Winthrop, Stimson's Brussels office, says: "DGXV is very small. It would be almost impossible for them to fulfil their function without outside help." Early on, lobbyists can have an enormous influence. "If one is creative in assisting them to reach a solution, it is possible to have a major impact," he adds.

Political clout

Another lawyer who has dealt with DGXV points out that lobbyists may identify problems that the commission has simply not forseen. This source says: "Sometimes, once we ask questions, they start to look at their own text without us really pushing. We are even asked to say what we think about certain things".

Once the internal consultation is over, the *cabinet* of a commissioner takes on added significance because accomplishing changes may require political clout. "We devote a lot of time to getting to know them," says a former commission official who is now a lobbyist in Brussels. "They are important. They actually make decisions." But at this stage changes are already harder to obtain. A veteran Brussels lawyer says: "Once the director-



Sutherland sought transparency.

general approves it and puts it before his commissioner, and the commissioner before the commission, it's really very late in the game. Too many people's egos are involved."

Formal proposals are sent by the commission to the council and European parliament. It is much more difficult to influence the text at this stage.

The parliament has more power since the passage of the single European act but remains an advisory body. It will assume real significance only after the Maastricht Treaty has been ratified, when it will acquire the right of veto over legislation.

The most significant area is the least accessible. Meetings of the council of ministers, where the compromises between member states are forged, take place in secret. Documents are confidential but may be given to lobbyists with good connections. It is possible to talk to officials in the national permanent representations to the council, but there is no way of being certain that issues are raised in council meetings. The secrecy at this stage highlights the need to start lobbying early.

The official responsible for the original draft will usually steer a proposal through the various legislative stages, and can be influential later in determining whether amendments are accepted. The key to successful lobbying is to identify this individual early and to stay in touch. "I always like to know whose hand is on the pen," says one lobbyist. "You cannot assume that it will trickle down."

Nothing published

Nothing is published in the official journal of the EC until the commission first presents its formal proposal. So how do you find out if there is a pre-draft text to lobby on? One lobbyist says: "You tend to hear from one source or another that the commission is working on something, either from one of the better European newsletters or because you see for lunch or a drink in the evening the sort of people who tend to know."

Last year, a high level group chaired by former commissioner Peter Sutherland called on the commission, in collaboration with the council of ministers, to start talks on opening the community's legislative process. The council has made noises but attempts by Denmark to televise council meetings have been vetoed by othermembers.

The contrast with Washington is startling. In the US, there is far more emphasis on a formal audit trail. Under the administrative procedures act 1946, a federal agency with rule-making authority has to publish any proposals to amend regulations in the Federal Register. A statutory consultation period follows during which members of the public may comment. All submissions are kept on file and form part of the public record, together with any reports commissioned by the agency concerned.

Members of the public may inspect the files and read the comments that have already been made. Private off-the-record meetings are restricted and the existence of a meeting must be on the record.

When the consultation period is over, the agency must base its decision on documents available in the public record and provide a statement of reasons, including reasons for ignoring objections which have been lodged. For the Securities and Exchange commission (SEC), consultation takes 30 or 60 days, or longer, depending on the issue. John Heine, a spokesman at the SEC, says: "Anyone can contribute, from a large securities house or law firm to my mother."

The US system has its critics. Many Americans complain that it is too lengthy, too adversarial and involves too many lawyers. Steven Kelman, professor of public management at Harvard University, says: "It would be impossible to make the system as closed as it is in Europe. There would be no serious constituency in the United States for turning it into a system where bureaucrats would just call in a few people for a cosy chat."

In fairness, this would be a caricature of the EC system if applied to DGXV. There is no right to be consulted, but DGXV has a reputation for openness. Calamaro at Winthrop, Stimson, says: "I have been extremely impressed by the way in which DGXV is open to private sector input and by how it internalizes that input". Brian Harte, head of European compliance at Chase Manhattan, also finds the system open: "One of the good things about the whole structure of the commission is that people are very approachable. If the need arises you can usually get in to see them. Certainly we have found this to be the case with DGXV."

Allen & Overy's Robert Strivens claims the process is much maligned: "On the whole, I think the system in Brussels is a good one. It's easy to identify the relevant people on any particular piece of legislation. They are willing to see you and to be persuaded if you have a good case and you put it well."

Informal approach

Martin Power, a DGXV official, defends the record: "The experience has been pretty good," he argues. "We don't normally pull proposals out of a hat. A lot of pre-consultation goes on with member states, albeit in an informal fashion." For critics of the system the informality is the problem. "It depends so much on the individuals involved," says one lawyer. "Some officials are delighted to discuss a proposal because they want to come up with a good product, and they know they don't know everything. But others will die before they tell you anything."

Should a system depend on such caprice? Brian Harte believes the personalities reflect the system. "In Europe it is much more informal. You know people and can easily ring them up to discuss issues of mutual interest."

Filip Moerman, a partner at Cleary, Gottlieb, has experience on both sides of the Atlantic. He praises DGXV's sophistication but believes the pre-consultation process should be more open. "It would be a lot healthier, because the commission, just like anybody that makes rules, will make mistakes."

making activity with providing investment services generally. They are grasping at straws."

One source in Milan believes the Italian government tacitly accepts that the SIMS law was badly drafted and contravenes the Treaty of Rome, but that it has still to convince the Italian parliament. "There may be some massaging needed there," he says.

The Italians have promised the commission speedy implementation of the ISD once the directive has been adopted by the council of ministers. This is expected before July. Italy became so notorious for its failure to implement EC legislation that a system to transpose directives into national law *en masse* was introduced, and its overall record has improved. But with Italian politics in chaos, it is not clear that the promise can be kept. "It's a very unsatisfactory way of proceeding," says one former official at the council. "There's no guarantee that they'll do it."

The commission is not obliged to sue Italy and other DGXV officials are wary. "All options are open," says Jean-Pierre Fevre, director for financial institutions. "They are blowing hot and cold on the SIMS question," says one experienced DGXV watcher.

He contrasts the current mood with the more robust approach of the former director-general, Geoffrey Fitchew, who recently returned to a top post in Whitehall. "Fitchew wanted to hang, draw and quarter them." ■