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## Transnational Financial Services—Current Challenges for an Integrated Europe

### Cover Page Footnote

Address given by Dr. Gerhard Wegen on February 27, 1992, as part of the Fordham University School of Law Graduate Colloquium 1991-1992, Transnational Financial Services in the 1990s.

# TRANSNATIONAL FINANCIAL SERVICES— CURRENT CHALLENGES FOR AN INTEGRATED EUROPE\*

DR. GERHARD WEGEN\*\*

*In this address, Dr. Wegen focuses on the challenges facing an integrated Europe. Dr. Wegen examines the existing regulatory scheme which governs the EC financial services industry. By discussing possible enlargement of the EC to include eastern and central European countries, Dr. Wegen addresses the growing need to develop and expand structural devices, both governmental and informal, to bind the EC. The basis for such a union must be the free movement of goods, capital, services, and persons. Dr. Wegen concludes by stressing that the EC must prepare for global competition, rather than struggle over matters of national pride.*

## INTRODUCTION

GOOD evening, Professor Malloy, ladies, and gentlemen. Thank you for your invitation. I hope I can live up to the standards you require from your students in their papers and presentations. It is a particular pleasure to be here because I, myself, took part in a graduate program some ten years ago. Additionally, I was always very predisposed favorably to Fordham Law School because the first book review I ever published in the United States appeared in the *Fordham International Law Journal*.

Turning to the subject, "Current Challenges for an Integrated Europe," I have to warn you that I am a practicing attorney, so I will not be able to embark on the economic side, either micro or macro, of the discussion. Second, as a lawyer, I tend to think in institutional frameworks more than structures. Also, to the extent speculation is required, it is a lawyer's imagination at work, so it is a very low speculative mind.

When I received the proposed subject for my address, I thought I would embark upon a presentation of the present status of the implementation and the completion of the internal market with a view to financial services. But when I looked more closely at the current challenges for an integrated Europe, I thought we might focus more on the challenges fac-

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ing integration. When we talk about "Europe," what Europe do we refer to? I want to, in the end, give you a short picture of what is happening in Germany as one of the least-regulated countries at this time.

## I. FINANCIAL SERVICES

It is appropriate to begin the discussion with the notion of financial services. I do not know whether the notion of financial services was defined by one of the previous speakers in the program—maybe not; I am not sure.

### A. *The Background*

Europe does have a working definition of "financial services" based on the British Financial Services Act, which was promulgated in 1986. When you look at the European Community (the "EC") side, I think, and this is my first thesis, you must interpret financial services and the preoccupation therewith much more broadly than you might technically in a very developed jurisdiction like the United States where there has been securities regulation in the financial services industries for a long period of time. And also, in the EC, no single level playing field for financial services exists. The EC is composed of twelve jurisdictions with differing banking systems. For instance, in Germany we have the universal banking system, as opposed to the separation of banking functions found in other countries like the United Kingdom.

Although the various EC countries have all forms of corporate institutions, such as partnerships and stock corporations, many problems vary across countries regarding corporate governance, disclosure requirements, buying systems, and corporate control. This variation has an impact on financial services.

The financial systems are different. The tax systems are different—we have twelve separate, individual tax systems within the EC. The business cultures vary largely. Consequently, when approaching financial services in Europe, a much broader notion applies than that applicable in the United States.

### B. *The Scope*

The following financial services exist in the EC:

First, there is banking. Already, the notion of what constitutes banking differs widely. For instance, in Germany we have a very broad notion of what constitutes banking. The notion of banking is much narrower in other jurisdictions.

Next there is insurance. The insurance industry is, again, largely divided in different countries.

Lastly, there are investment services. Again, the notion of investment services varies to a large extent. Investment services are comprised of stock exchange regulation, securities regulation, investment funds regula-

tion—at the EC level we talk about UCITS—and then, regulation of investment service providers. I would also include mutual funds. We also have a variety of special banks, which may not be universal banks but still fulfill certain functions. These constitute financial services.

### *C. The Regulation*

An examination of the nature of the regulation of financial services reveals in two groups of activities:

First, there is the regulatory side. Within the regulatory side, I would distinguish the general regulation of financial services. In the EC this is accomplished mostly by Directives. Next is the general regulation of banking activities. In Europe, a distinction is made between the regulation of disclosure requirements and that of accounting. As I said already, accounting methods vary largely as do disclosure requirements. Much of what the EC does at present is geared toward the harmonization of disclosure standards. The final category of regulatory activity is the supervision of the banking regulatory work. I would call this financial services regulation.

The second part of the regulation of activities is the civil-law or contract-law side. Banking may be regulated by either public law standards or from a private law perspective. There again, one must distinguish two levels. Conflicts of law issues are implicated when one must determine the law applicable within the EC to a concrete banking problem. At the same time, substantive rules applicable to banking contracts in detail must be applied.

This is the regulatory side in general terms. Now I come to the third field which is of importance in EC perspective. These are fields that are related to financial services and that we have to take into account because the EC possesses no unified legal system. First, financial services consistently implicate tax questions. So if you deal with financial services in Europe, you must also consider tax questions—for instance, the indirect taxation of securities transactions.

The second field which is of importance concerns general corporate matters. Here I would count, first, M&A-related matters, transparency, notification requirements, and the whole group of problems surrounding barriers to takeovers. I just want to alert you to the fact—I am not sure to what extent this is known in the United States—that much attention has been devoted to various takeovers in Europe. For instance, a study for the EC Commission was performed by Booz Allen an acquisition advisory service, and Coopers & Lybrand performed such a study for the Department of Trade & Industry in London.

The third area of the law which one must take into account in financial services concerns matters pertaining to disclosure and accounting. The first real comparable figures which were developed in Europe are based on the “balance sheet” directives, as we call them, which were imple-

mented by national legislatures in the mid-1980s. So, for the first time, a balance sheet of a German company, a French company, and an English company became comparable to a certain extent. Nonetheless, the system is still not fully accessible to Americans because here, again, the EC system deviates largely from the United States system.

After considering the above regulatory concerns, a host of other issues remain. For example, all regulations concerning capital movement and capital restrictions must then be taken into account. Moreover, another field, which at first glance is not obvious, is the field of consumer protection. The EC Commission has dealt in a variety of directives and recommendations with certain aspects of consumer protection as it also relates to banking and financial services. For instance, consumer loans are regulated by an EC directive as is the computation of effective interest.

The next field of law to be taken into account would be competition law and policy, in particular merger and control regulation and also our state aid problems, which may come in disguise when companies are being bought or financed by the state. Then, I think, also of importance are, in general, economic, monetary, and political matters, because these form the business climate for certain financial service related activities. Finally, financial services must also be seen from the domestic, or national, perspective.

#### *D. Notional Problems*

I think the above gives some idea of what areas must be covered and considered in examining the regulation of integrated financial services in Europe. As I make this such a broad outline, I can assure you that all of the directives, for instance, concerning financial services in this large sense are being denominated in Europe either as the emerging European capital markets law, or the emerging European securities regulation, or the emerging European corporation law or business enterprises law, depending on where the respective lawyer is domiciled. Is he or she a corporate lawyer; is he or she a securities lawyer possibly; is he or she a banker? It is not clear what changes have really emerged.

The bundle of rules that must be taken into account cannot be put easily into one basket. That is a big problem. Corporate lawyers, banking lawyers, and insurance lawyers all speak of financial services, but no one really can be expert in all of the fields.

Having said this, I excuse myself for possibly not being able to answer your precise questions at the end, first, and second, also to identify where I come from because this proves important. I come from the corporate side, M&A side, and securities regulatory side. I am not coming from the banking side or the insurance side. Depending on where you come from, you regard financial services differently.

## II. WHAT EUROPE?

Now comes the second part, challenges faced by an integrated *Europe*. There exists, as the core notion, the European Community, today comprised of twelve states. The EC started with six states in 1958 and was subsequently enlarged to nine and then to twelve states.

### A. Basic Challenges

The first major challenge, or task, is the completion of the internal market. The Program 1992, "Fortress Europe," the single financial market, will be dealt with in some detail later. The second current status-related matter is applications for membership in the EC. Applications have been lodged by Austria and Finland. An application has been announced—or let's say is anticipated—by Sweden. Interest has also been voiced by Malta and Cyprus, and an application had been submitted from Morocco. Lastly, the EC is faced with the ongoing problem of Turkey. This is the second issue, the enlargement of the EC to include certain other states.

The third description of the present status is that some states close to the EC have embarked upon what I would call parallel legislation. They are not yet members of the EC, but they anticipate becoming members in the near future, or they anticipate trying to reduce the barriers to entry they face into the Common Market by introducing a similar or comparable system to the EC. The most obvious example is product liability, which is based now on a directive. Austria, for example, has implemented even more EC-friendly legislation than many EC states.

As an aside, it appears that the banking laws of Czechoslovakia, Hungary, and Poland are much more in line with proposed EC directives or EC Directives already promulgated than are many EC member states.

The Treaty on European Union, what we call the Economic and Monetary Union (the "EMU"), that is the single currency approach, the Accord of Maastricht, and the establishment of a European central bank are the next developments upon which I shall focus.

I will also focus for a few moments on the European Economic Area (the "EEA") because that is another important recent development. The EEA will be comprised of the twelve current member states of the European Community, along with the remaining EFTA states which include the Nordic countries (Finland, Norway, Sweden, and Iceland) and Switzerland, Austria, and Liechtenstein.

The next group of problems is presented by association agreements. We have, still, an old association agreement with Turkey. In December 1991, the EC concluded three association agreements with Czechoslovakia, Hungary, and Poland. These association agreements deal with trade promotion and with the prohibition of new customs levies and duties. But they also deal with the establishment of new businesses, the requirements of national treatment, the protection of certain industries, and the

movement of capital. Association agreements are also an area which must be looked into when dealing with financial services.

### *B. New Applicants*

The next European angle, so to speak, is the geographic reach of new or proposed applicants to the EC. I think if we now examine the list of pending or upcoming possible applications for membership in the EC, you will plainly see the challenges to EC wide financial services.

This categorization is "Wegen-speak," I must say. I tried to delineate the different applicants.

In the first category I would put countries situated close to current EC states and members of the EEA—namely, Austria and Finland, which have applied, and Sweden. Iceland, Liechtenstein, Norway, and Switzerland may also apply. Iceland seems unlikely to apply at this time. Nonetheless, this group must be considered as "close countries" because they are prepared to sign the EEA treaty. As a second category there are other western countries, namely Malta and perhaps Cyprus. Then we have in the third category the southern countries. Only Turkey falls into this classification. A fourth category is comprised of eastern or central European countries.

I think that with respect to eastern or central European countries, the European Community is confronted with a formidable task greater than was faced in the mid-1970s. You may recall that in the 1970s a big debate raged regarding the accession of the Mediterranean countries: Greece, Portugal, and Spain. The EC felt compelled to admit them because they had just been liberated from dictators. As a way to pacify these countries and to try to bind them into a stable economic and political superstructure, they were admitted quite early. This pacifying function, as I would say, has reappeared, in my opinion, with regard to the eastern and central European states.

In a subgroup I would put the associated countries, namely Czechoslovakia, Hungary, and Poland. In a second subgroup I would put those which voice an interest in EC membership: the Baltic states—Estonia, Latvia, and Lithuania. The third subgroup is quite broad, including countries like Russia, the Ukraine, and other member states of the Commonwealth of Independent States. In the fourth subgroup I would put the former Yugoslav states. I would distinguish between Slovenia and Croatia, certainly, on the one side, and the other remaining states, on the other.

What is left are countries such as Bulgaria and Romania. If you look at this long list, I think you see what a formidable task we have to deal with.

### *C. Relations to Third Countries*

The real challenge, however, in that respect is that we have to move

toward greater integration to varying degrees with the countries I name above, but we must also open up the EC to developing countries. If we integrate in a closed way, we build a greater "Fortress Europe," creating a barrier to a stable Europe and to the rest of the world.

### 1. GATT

I think the focus here must be on the GATT Uruguay Round on the multilateral side, and then on certain bilateral relations, in particular with the United States, on the other. It is important to recall that the Uruguay Round of GATT is threatened mainly because of agri-business interest groups. It is often overlooked that the Uruguay Round of GATT, for the first time, also attempts to regulate services, in particular international banking, telecommunications, transport, and insurance. The progress which could be made by liberalizing these areas and by eliminating privileges of domestic service providers is endangered by a dispute on agricultural subsidies.

You may know about the Dunkel paper, written by Arthur Dunkel, which suggests reducing agricultural subsidies by ninety percent. Agribusiness, if I am correct, accounts for seven percent of the gross national product in the EC. This misplaced emphasis on agriculture negatively impacts the financial services industry. Something must be done to alleviate these subsidies.

### 2. Bilateral Relations

Let me turn to bilateral developments. There is integration in Europe on a large scale—on the multilateral scale in GATT, and now bilaterally, in particular, with regard to the United States. You may know that throughout the IOSCO meeting in Fall 1991 in Washington, the EC and the Securities and Exchange Commission (the "SEC") signed a joint declaration on cooperation. The EC cannot bind member states. However, important developments between the EC and the United States will avoid large-scale friction. As *The Financial Times* noted earlier this week:

The European Community is likely to enter into direct negotiations with the Securities and Exchange Commission, the U.S. securities regulator, over removing obstacles to the listing of German and other European companies' shares on the New York Stock Exchange.<sup>1</sup>

There was a meeting in Frankfurt between the German stock exchanges, the New York Stock Exchange, the Bundesbank, and German government officials. They could not agree because the big German companies we are talking about Daimler Benz, the big banks, and the like who do not want to disclose based on U.S. laws certain information on profits. That is a real problem. Now comes the conclusion of the article:

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1. David Walles, *EC, SEC May Hold Talks On New York Listing*, *Fin. Times*, Feb. 25, 1992, § 1, at 29 (European ed.) (on file at Fordham Law Review).

Yesterday's statement from the Federation of German Stock Exchanges said the question of listing requirements was a problem which had a fundamental bearing on relations between the U.S. and the whole of Europe, and for that reason, negotiations should be handled at an EC level.<sup>2</sup>

So the Federation of German Stock Exchanges, the German Bundesbank, agreed to delegate powers to the EC voluntarily. Despite the fact that this is a question which relates to German sovereignty, it is considered so significant that Germany will delegate such authority to the EC. I think that is an indication of the direction in which responsibilities and jurisdiction over securities matters will be delegated to the EC Commission in the future.

#### *D. International Organizations and NGO'S*

We must still address the question of "what Europe?" This leads me to the next topic surrounding integration. Beyond those state-inspired or state-run European developments, there is a host of organizations in Europe, partly outside Europe, which deal with financial services matters and try to harmonize them. IOSCO, the securities regulator organization, is an important organization where the SEC and other regulators are represented. Just to give you an idea, Germany does not have a central regulatory authority. Consequently, the Federal Ministry of Finance attends these meetings.

We have the Bank of International Settlement in Basel, and the Cooke Committee in particular, which deals with problems of capital adequacy and the framework thereof; we have the European Capital Markets Group; we have the International Capital Markets Group; we have the Fédération Internationale de Bourses des Valeurs (the Federation of International Stock Exchanges); we have a Federation of Stock Exchanges of the EC. All these bodies try to communicate and to develop a common framework. They are not bound by the same structural limitations which bind the EC. A great deal of informal, non-state-dominated communication occurs.

Then we have new institutions, like the European Bank for Reconstruction and Development (the "EBRD"), which serve investment banking functions; we have the European Investment Bank in the EC framework; and we will have soon the European Central Bank. There is also an informal layer of communications which will certainly be important in defining what will be happening in the future.

### III. STEPS TOWARDS INTEGRATION

In discussing, my next topic, an *integrated* Europe, I want to come

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2. *Id.*

back to three points: the single market, the Economic Monetary Union, and the European Economic Area.

### *A. The Single Market*

As I said earlier, the real challenge is to forge a union, at least to a certain extent, from very different countries. The basis is to provide for free movement of goods, capital, services, and persons. That is what the internal market is all about.

#### 1. The Basis

The basis of this is the Single European Act, which you are undoubtedly aware of, which imposes a deadline of December 31, 1992. That is where "Europe 1992" comes from. No one seriously believes that the completion of the internal market will occur at midnight at the end of this year. It is an evolving process.

In 1985, a Commission white book was circulated which addressed the removal of physical, technical, and fiscal barriers, and identified three hundred individual measures to be taken. The basic principles should be recalled because they are also important to the integration of financial services. These are two principles applicable to the completion of the internal market within the EC. First, the setting of minimum standards to be complied with in order to have goods or services circulate freely within the European Community. The second principle is that of home state control. Where a license has to be given for a specific activity, such as to an insurer or a bank, once this license has been granted, then the services of this licensed enterprise may freely be offered throughout all of the EC. No specific petition or license from any of the other EC member states is required. The home-state control principle is of particular importance to the financial services industry.

The EC will set certain minimum standards with regard to capital adequacy, solvency, banking supervision, and insurance supervision. If these minimum standards are met and an institution is duly licensed, it may offer services freely within the EC. Today, this policy is referred to as the "single license" or the "Euro passport"—in other words providing home-state control.

It should be noted that once a third-country institution is licensed in one of the EC member states, these principles of free circulation apply also to that third-country national. This principle should not be underestimated.

#### 2. The Instruments

The instrument for licensing is the Directive which is geared towards the individual member states. Each member state must implement the underlying policy of the Directive in the form of national legislation or regulation. The Directive is plagued by the problem that it requires a

separate implementation act by each member state. Recent European Court of Justice case law, however, has done away with notorious non-compliance in two ways. The Court established late last year in an Italian case that if a state does not implement a Directive within the timeframe set forth in the Directive and damage occurs to the detriment of an individual of that member state, the state is liable to the individual for damages. This decision is a rather important sword for implementation.

Second, the European Court of Justice held in another decision that, to the extent a directive is self-executing—a concept which is taken from public international law—even if implementation of the Directive has not been effected, it is binding and the individual derives rights therefrom.

### 3. Implementation

Now, I think the most important aspect of the completion of the internal market for the financial services industry is certainly the establishment of a system of supervisory regimes. If we have home-state control and minimum standards, it is left to each member state to impose additional requirements for its own institutions. The minimum standard may be implemented very flexibly in a given state in order to attract more banks, insurance companies, or financial services. This principle should not be unfamiliar to the United States. In the United States, Delaware has initiated flexible corporate governance rules relative to other American states. The EC will have similar developments, certainly, in the financial services industry.

Let me take a step back with regard to the completion of the internal market as the first integrative step. Certainly it is incorrect to speak of integration as deregulation. Many EC member states' implementation of Directives is their first attempt at regulation of an entire field. To some states, it may be a fortification, an additional regulation, of certain areas.

The main tasks are to ensure the functioning of the market, the protection of investors, and the integrity of the market. All of these concepts are well known, but they have not been implemented in many EC member states in a visible regulatory scheme. As a result of integration, the EC will develop market supervision outside stock exchanges, protection against insider trading, equal treatment of shareholders, and internationally acceptable minimum disclosure notification requirements.

#### *B. Economic and Monetary Union—EMU*

Let me turn for a moment to the Agreement on European Union. This agreement is the Maastricht Accord, which was concluded only recently and has been published in its final version only three weeks ago. I have studied the agreement and attempted to discover provisions relating directly to financial services. I can report that the Agreement on European Union, introducing economic and monetary union, does not impact di-

rectly the financial services industry. It does, however, impact the whole economic basis of the EC because with a single currency and with the establishment of a European central bank, many coordinates of the financial services industry will change.

While the impact will be enormous, the impact on direct regulation of financial services will be rather minimal. What is important, is that the EC Commission is empowered with vast new authority over a variety of matters. While unrelated to financial services, these powers, for instance, stretch to industrial policy, research and development, and other areas.

In particular, the agreement is framed as an amendment to large portions of the Treaty of Rome and the other EC Treaties currently in force. If you compare the changes, the whole EC Treaty framework will change drastically. What is of particular importance are such matters as the introduction of EC citizenship, the introduction of economic and monetary union, the introduction in three stages of a single EC currency, and the introduction of a joint foreign and security policy, which may lead to joint defense. The principles which follow from these provisions are an attempt to achieve coherent policies relating to industry, defense, monetary and currency perspective, and continuity. A new organ or framework, the European Council, will be created. The European Council is separate from the Council of Europe or the Council of Ministers and is a body comprised of the heads of government of the EC member states as well as the EC Commission President.

It comprises, among others things, the draft articles for the European Central Bank and the European System of Central Banks. And, it will certainly transform the capital markets in Europe.

### *C. European Economic Area*

The next step to integration I want to mention is the European Economic Area Agreement ("EEA"). This agreement is in the draft stage only. Negotiations are currently underway among the EC member states and the EC, on the one hand, and the EFTA and the EFTA states on the other. The EEA is a public international law treaty which must be ratified by the signatories. Ratification is likely to meet much opposition, for instance in Switzerland. Switzerland must conduct a referendum, which would require the majority of voters individually to consent and the majority of the cantons, the individual states, to consent to such a treaty.

The EEA leaves intact the right of any EFTA state to apply for membership in the EC, and would largely expand the applicability of EC law to the individual EFTA states. The EEA provides for the same four fundamental freedoms as does the EC.

One EEA article provides that "financial services and services, all of what has been regulated by the EC previously, is applicable in the EFTA states if not otherwise provided for in an annex." This annex, which is not yet published, but I have reviewed, has approximately twenty pages

and is immaterial. The annex makes certain exceptions to the applicability of EC rules in the financial services area. First, it excepts the applicability of certain Directives to certain EFTA member states by 1996. Second, it makes certain exceptions to the insurance business. There are no exceptions for EFTA member states with regard to the applicability of EC directives in investment services or banking. In practice, financial institutions, in particular banks and insurance companies, can be based on the same principle of home-state control and minimum standards, and consequently float freely within the EC and the EFTA states. If, for instance, a third-country institution, such as an American bank, were to be established in Switzerland or in Austria, then the license in that EFTA state would authorize that third-country enterprise to offer services freely within the enlarged EC-EFTA territory.

Now I have dealt with three major areas of integration which may lead to confusion—the EC level completion of the internal market, the new treaty on economic and monetary union, and the draft European Economic Area Agreement.

#### *D. Further Integrative Steps*

There are further elements of integration in financial services which should be mentioned. One is that the EC Commission has started to promulgate regulations—directly applicable rules inventing or introducing corporate entities—on the EC level which also apply to the financial services industry.

##### *1. The Legal Level*

The one conspicuous example you may know of is the European Economic Interest Grouping. It is a European entity which is not subject to the national laws, but to genuine EC law. If the EC regulation does show a gap, then the national law in the state of organization governs and fills any gaps in regulation. Having said this, integration in my opinion goes further and is accomplished more expediently by harmonization of contract law. As well as on the contract-of-law level and on the material level of substantive law, new rules must be taken into account. Primarily, the EC Convention on the Law Applicable to Contractual Relationships must be implemented by the EC member states. While partially implemented, this convention in the final analysis will lead to conformity towards third-country nationals and EC citizens because the same conflicts-of-law rules govern. I think that is something you will appreciate given the fact that the United States has fifty-one different legal systems.

The EC not only has general conflicts-of-law rules, but has partially introduced special EC conflicts-of-laws rules. For instance, for insurance conflicts, the EC has a special conflicts-of-laws rule. And, of course, the EC has substantive law rules with regard to specific regulatory items or items normally provided for in contracts, such as consumer protection.

## 2. The Factual Level

Then, of course, there is integration which comes about by simple monetary and economic pressures based on the prospect of a single currency and a single European central bank. This creation of a single ECU currency unit on the European market will lead to a drastic minimization of certain transactional costs in currency contracts and foreign exchange dealings. It will lead to more comparable and competitive financial products, less direct currency fluctuations, and the resulting stable currency system.

## 3. The European Central Bank

A word about the European Central Bank. You may know that debate has ensued regarding the seat of the new European Central Bank. In light of the Bank's importance, the debate has been fierce. The Germans were unable, for whatever reasons, in the Maastricht Accord to establish the European Central Bank in Frankfurt. They compromised on a dilatory basis by agreeing that the situs of the Bank would not be determined until the end of 1992. Amsterdam, London, and Luxembourg have also expressed interest in hosting the institution.

The location of the Bank has not only symbolic importance, but real value. The Deutschmark was and is the second leading currency in use in the world. Because the Bundesbank, or Federal Central Bank, has been the model for the draft articles of association, a political dispute has developed centering on whether the EC should have an independent central bank or a central bank framed more along the lines of the French model. The dispute has been decided in favor of the Bundesbank model. Also, I think, the Deutschmark was in many ways, for better or for worse, the lead currency in Europe, and it would be neither possible nor appropriate to alter the status quo. That was the argument made last week by Chancellor Kohl and by the president of the Bundesbank.

## IV. CHALLENGES ON A DOMESTIC LEVEL—GERMANY

I am somewhat partisan in this respect. I would like to indicate the present structure of Germany in general terms.

### A. *The Present Structure*

Germany's present structure is characterized by a universal banking system with a broad banking definition. Virtually every security-dealing activity is classified as banking and requires a banking license under German law. We have an archaic marketplace with no developed capital market structure. This is easily demonstrated with a few examples. Germany has approximately 2,500 stock corporations. In contrast, Germany has approximately 350,000 limited liability companies, the shares of which are intangible and not freely negotiable. In addition, approximately 30,000 general partnerships and 130,000 limited partnerships ex-

ist. Thus, the bulk of business and corporate activity is concentrated in non-stock corporate entities. Of these 2,500 stock corporations, only 650 are listed on any German stock exchange. Of these 650 stock corporations, approximately thirty account for three-fourths of all turnover on German stock exchanges. While market capitalization exists, most trading is limited to these thirty stock corporations' shares.

Germany does have special proxy rules where banks exercise proxies for those who do not specifically provide voting instructions. Germany has a particular system of corporate governance; we have eight stock exchanges. Germany has no insider trading laws, no transparency rules and no central supervisory authority similar to the SEC.

### *B. Towards a German Financial Center*

In mid-January 1992, the German Federal Ministry of Finance published a policy paper<sup>3</sup> in which the ministry introduced the concept of a federal supervisory agency that would supervise securities transactions both off and on the German stock exchanges. No such agency has been established yet. Debate continues as to whether this agency should be composed of the individual state agencies, or whether it should be a new federal entity modeled after the SEC. No set of rules exists, no code of conduct is in place, and no supervisory mechanisms are in place.

Germany does have federal supervisory authorities for insurance and banking businesses. From a conversation I had recently, it is apparent that the Federal Banking Authority has declined to assume responsibility for the securities markets. Therefore, a new authority must be created with a new staff, with its seat in Frankfurt; with a new set of rules governing insider trading, transparency, and notification requirements; and offering requirements for public sales of securities. It is a massive program in an environment which heretofore was unregulated.

Germany is not alone. The Italians, the Portuguese, and the Spanish have to deal with this problem. The French have a somewhat more regulated system in place. But by far the most developed system exists in the United Kingdom because of the Financial Services Act and the fact that the British do not have universal banks but rather a system that separates banking by function. Germany's universal banks were particularly successful in making it clear that they wanted to be supervised only by the banking agency and did not want to be supervised by a new investment services, capital market-oriented supervisory authority.

We are now confronted with the problem of whether the banks and the other securities houses would be on an equal footing. The big debate is whether capital adequacy and other factors could be evenly distributed between these types of institutions.

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3. See *Towards a German Financial Centre*, attached hereto as annex I.

## V. OUTLOOK

I want to close my remarks with a short look towards the EC's immediate future based on these new developments.

Let me say prior to concluding that I think the major challenge faced by the EC is to continue what I would call the "legal fine-tuning," the implementation of Directives into national legislation or regulations, and the completion of the internal market. One must not forget, however, the political dimension of the economic and monetary union and the enlargement of the European Community. These political debates are the real challenge ahead for the EC.

In recent years, the financial services industry in Germany, in particular banks and insurance companies, expanded strongly into other member states with considerable acquisition activity and strategic alliances in order to prepare for the opening-up of the markets and in order to be present in the major markets of Europe. What we see at present is that these institutions have stalled in their expansion for fear of competition in their domestic marketplaces. Now I think that the present goal must be to secure and to stabilize the domestic markets. Domestic customers are the most important basis, and international expansion comes second.

To a certain extent the formation of specific subsidiaries in other EC member states and mail drops will be used to take advantage of less stringent supervisory mechanisms. Special financial products will be offered only in those markets where they can be offered at most attractive terms. Attractive terms include tax benefits.

Eventually we will also see that differences in the degree of supervisory mechanisms will not play a significant role in financial services; such differences will disappear. Thus, it would be irrational for individual EC jurisdictions to emphasize small degrees of difference. Instead, EC member states should eliminate minor differences in the supervisory regimes and construct a EC-wide system.

Furthermore, I think an interesting feature will be that special financial products will become marketing devices. These devices will create brand loyalties among the public. I do not know to what extent this has happened in the United States, but the expectation is that new products and brand names will be created. In the future, it will be less important in which EC member state a particular financial institution is domiciled. Instead of worrying whether the institution is a French bank, an English merchant bank, or a German investment services provider, the institution's name recognition will be key to its survival. Is it "Deutsche Bank," or is it "Crédit Lyonnais," or is it "Hambros"?

The expectation is that the ECU will create the most important single currency area. What we term, for instance, Europe's "financial centers"—London, Paris, or Frankfurt—will become a matter of regional infrastructure policies. No longer will such determinations be a goal for national pride. That is certainly a development that will ensue.

Finally, the EC playing ground will be a playing ground in preparation for global competition. Only a few financial institutions within the EC are prepared for global competition at this time.

ANNEX I  
*TOWARDS A GERMAN FINANCIAL CENTRE\**

*An outline programme for the development of a financial centre in Germany*

- I. *Role of Germany as a financial centre within the global context of the financial markets*
1. *Objective of the Federal Government's financial centre policy*

The Federal Government gives high priority to the active development of an internationally competitive financial centre in Germany. The market for financial services is a prime growth area. As the world's third industrial country, Germany needs a fully-developed financial market capable of servicing all international requirements. For its future structure, the following elements are of central importance:

- a sound and dynamic universal-banking system,
- an internationally competitive stock exchange system,
- and
- an entrepreneurially-oriented, high-capacity insurance market.

2. *Framework conditions for an evolving German financial market*

Following on the already established freedom of movement of capital, the advent of the Single European Internal Market on January 1, 1993, bringing with it complete freedom of establishment and services, is giving a new impetus to the development of a German financial centre. The advantages the Internal Market will bring for financial services markets will, however, become fully apparent only when the Economic and Monetary Union is complete and Germany, and its financial services industry, is embedded in a single currency area.

By this date, it is envisaged that the financial markets of the member states of the European Community will have coalesced into a viable single European financial market capable of competing with the international financial centres of New York and Tokyo. This presupposes financial intermediaries through which the future European Central Bank can implement its monetary policy objectives and create the monetary framework for the real economy.

It is part of our fundamental understanding of European cooperation that intra-EC integration should go hand-in-hand with an opening-up to the world economy. The Federal Government has always supported open financial markets, both within the EC and vis-a-vis non-member states. The Uruguay Round is a further framework within which it seeks maximum and binding liberalisation commitments.

Germany has in the past achieved considerable success with its con-

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ception of liberal conditions for financial services. This approach is also a pointer for the future. The reputation of a financial centre is, however, also dependent on the existence of generally recognised legal standards that ensure integrity of the system and protection of investors. Deregulation and regulation must, therefore, be coordinated in a logical scheme.

Flexibility, an interest in innovation and product competition in the development of financial instruments must not be unnecessarily hindered by the legal system. Over-enthusiastic experimentation, however, could lead to conflict with the need for a soundly-based financial centre.

The German "universal" banks, with their full range of banking services, have an internal risk-balancing mechanism which is a significant factor in the stability and product range of the German financial sector. A sound banking system and functioning banking supervision have prevented lasting upheavals in the German financial system.

Market supervision in the securities industry that, beyond the existing legal supervision of the stock exchanges by the *Länder*, would combat distortions outside the organised capital market does not yet exist in Germany. Its creation is urgently needed, since it is today regarded as a necessary element in an international-standard financial centre. Such supervision should, like that in the banking and insurance industries, be entrusted to a central federal authority, since its functions are cross-*Länder*, because it must achieve uniformity of supervision and because the increasing international cooperation of securities supervisory authorities requires a central contact point. A federal authority, as such a central supervisory body, meets such international standards.

### 3. *Challenges for the German financial centre in a time of change*

The increasing capital requirements of industry and the state in order to manage structural change, the high savings rate of the private sector and the growing need for risk insurance have in the recent past enabled the financial services sector to achieve above-average growth, in Germany as well. This development is accompanied by a tendency to global integration of financial markets which impacts on international cooperation in the deregulation and new regulation of markets. This process is reflected, for example, in the EC's internal market programme, in the (initially unsuccessful) banking reform endeavours in the U.S., in the modernisation of the financial services industry in Japan and in far-reaching stock exchange reforms in important financial centres. The goal of all these endeavours is to enhance the performance capacity of the financial sector and strengthen the growth potential of the national economy. The optimal supply of capital to businesses and public budgets can be achieved only by a financial services industry which is modern and efficient, yet also stable. This is a central requirement for overall economic growth and employment. In this context the German financial centre is in competition with the other great financial centres—Tokyo, New York, London or Paris.

The enormous financing efforts required for reconstructing the economy of the new *Länder* and the ongoing investment and modernisation requirements of a competitive economy require the presence of an efficient German financial centre able to offer domestic and foreign markets competitive transaction costs, transparency, financial instruments and quality standards.

In the financing of the development of central and eastern Europe, the German financial centre is set to assume a key role. Germany's geographical situation, traditional relations to its eastern neighbours and experience in the restructuring of the planned economy on market lines all argue for a pivotal role in the channelling of international funds into the reforming states. A decisive factor for the opening-up of the new markets in central and eastern Europe is, however, a yet stronger presence and readiness to help development on the spot, in particular through financial intermediaries. In the race for maximum access, we cannot afford to lose touch with competitors who are all set to go.

These requirements are reflected in the Federal Ministry of Finance's proposal to integrate the hitherto largely uncoordinated supportive measures of the German credit industry and securities exchanges in constructing organised capital markets in central and eastern Europe and treat them as a matter of common concern. Such an instrument of coordination and project vehicle could be provided by a consolidation of the financial groups concerned in the form of a "GmbH" (limited liability company). This proposal was welcomed by the participants in the second "German Financial Centre" conference at the Ministry on 30 October 1991. Work on a preliminary concept has already begun. The federal government will to a limited extent be involved in the financing of projects.

## II. *Aims and responsibilities of the players*

### 1. *Concerted action on the German financial centre*

In the active creation of a modern and competitive German financial centre, state measures and private-sector initiatives must go hand-in-hand. The federal government sees its role above all as a regulator in the creation of the framework conditions for an internationally competitive financial market. The Federal Minister of Finance is available to the *Länder*, the regional stock exchanges and market players as a contact and reference point in the context of swift progress in the technical and organisational development of the stock exchange. This readiness was welcomed by the participants in the second "Financial Centre" conference at the Ministry on 30 October 1991. Follow-up contacts have since been made with the parties concerned.

### 2. *Link between market economy and technology*

The elements of the financial centre concept must be in line with mar-

ket economy principles. Economic and fiscal policy must support, not undermine, this strategy. Lasting success will not, however, be possible unless the financial markets have access to the latest technical and organisational facilities. The stock exchanges, which are essentially financed by the banks, must therefore maintain their efforts to exploit modern microelectronics and communications technology to develop the stock exchange system and optimise its organisational structure. A prime objective must be to hold transaction costs (e.g. stock exchange fees) at a competitive level and at the same time to enhance the transparency and liquidity of the market and the safety of transactions.

III. *Factors in the creation of a modern, competitive financial centre, with a review of the improvements already implemented and currently under discussion*

1. *Competitiveness of a financial centre is determined by three factors:*

- embedding in an efficient national economy with consistent and tension-free growth on the basis of a stable currency and sound financial policy;
- liberal fiscal and legal framework that does not impede financial transactions and investments and facilitates an efficient allocation of financing;
- efficient bank, stock exchange and insurance system with functioning market supervision.

2. *The federal government has over the last few years enhanced the attractiveness of Germany as a financial centre through the following measures:*

- creation of the framework conditions for an options and futures market under the 1989 amendment to the Stock Exchange Act;
- abolition of the taxes on stock exchange turnover, capital investment and drafts/bills of exchange as at 1 January 1991/1992;
- removal of the approval procedure for the issue of bonds under §§ 795, 808 German Civil Code (BGB) as at 1 January 1991;
- continuing development of the federal government's credit instruments;
- opening of the futures and options markets to investment companies;
- expansion of investment opportunities for investment and insurance companies.

3. *Important organisational and technical improvements carried out concurrently by the market players, such as:*

- consolidation of central depository banks;
- concentration of stock exchange technology at the German Securities Data Centre;
- foundation of the German Futures Exchange;

—upgrading of information and processing systems, introduction of an electronic securities trading system.

The electronic trading systems (IBIS, MATIS, MIDAS) developed by the market players and the discussion on further development of computer trading with an integrating “uniform electronic trading system” (the “EHS”) show that the use of modern technology, along with cost-cutting measures, are rightly understood as a decisive competitive factor. The German securities processing system, already an international leader with its two-day settlement time, is well on the way to a same-day or even instantaneous settlement. International competitiveness must, however, also apply to stock exchange fees, which are determined by the stock exchanges on a self-administering basis. The concept of a “German Stock Exchange AG”, as a coordinating entity for central stock exchange services for all German stock exchanges, is aimed at the creation of a supra-regional market infrastructure necessary for a modern financial centre. The progress achieved between the parties concerned in the conception of a “German Stock Exchange AG” and the participation of the regional stock exchanges in the IBIS system are specifically welcomed by the federal government. Still pending decisions will be taken rapidly.

#### IV. *Strategic elements for a financial centre concept*

##### 1. *At the centre of the discussion on the attractiveness of Germany as a financial centre are:*

##### a) *the technical and organisational facilities of the stock exchange, raising two issues:*

- role of the federal system, with its eight regional stock exchanges, in relation to a central stock exchange;
- efficiency of the traditional floor trading exchange with the official currency broker system in relation to securities trading in the computerised exchange;

##### b) *an updated stock exchange law:*

- development of market supervision in line with international standards to counter distortions in the securities markets (including outside the exchange) and the establishment of a central authority on the federal level;
- protection against insider trading, equal treatment of shareholders, internationally accepted minimum disclosure standards, balanced composition and function of the stock exchange Board and tailoring of stock exchange law to the conditions of the computerised exchange;

## 2. *Role of the federal government*

### a) *Role of the federal government in the technical and organisational landscaping of the German stock exchange*

The technical and organisational landscaping of the stock exchange must, like other areas of the financial system, be subjected to ongoing review, including in the light of proven structures. The important contribution of the regional exchanges to the development of the regions and the introduction of small and medium-sized enterprises to the organised capital market is beyond question. This service of the regional exchanges will also be needed in the future. There can, however, be no guarantee of a continuing existence for any one stock exchange. Remaining economically competitive must be the task of the regional exchanges themselves. At the same time, the German financial centre, if it is to compete with the great stock exchanges of the world, must also possess a strong, internationally competitive central stock exchange. Stock exchange federalism must develop further in this direction. The federal legislator's task is to shape the framework conditions of the German stock exchange system so as to strengthen stability and confidence in this important sector of the capital market.

This has the following implications for the strategy of the federal government:

aa) The legal framework conditions must not impede technical development. The computerised stock exchange and floor trading together comprise the stock exchanges' dual product system; the market players must decide for themselves which they accept. This is also how the situation is viewed by the determining forces on the German stock exchange scene. The regulatory framework must provide for equal competitive conditions for both systems and non-discriminatory access to either system for the market players.

Decisive factors in the competition of the two systems are the speed and costs of contract processing and liquidity availability. In floor trading, liquidity (at least as far as the stock markets are concerned) very largely derives from the independent securities brokers and official currency brokers. If in the past German stock markets have, by international standards, proved highly liquid and efficient, in particular on days of a critical nature for the markets, this is significantly due to the ability and readiness of the two groups of brokers to provide such liquidity. It remains to be seen whether similar liquidity-assuring vehicles will emerge for the computerised exchange.

bb) The concept of a "German Stock Exchange AG" in which the regional exchanges participate is a decisive breakthrough, combining the advantages of a stronger centralisation of the services necessary for the exchange business with the opportunities offered by the further development of the regional exchange model. The concept of the Frankfurt Securities Exchange and the proposals put forward by the

regional exchanges are a good basis for a consensus. The federal government has offered its services to the parties as a contact point in order to speed up the consolidation process. The federal government also sees itself as having an interventionary role when developments emerge that run counter to its regulatory conceptions.

b) *Federal government and Länder as the architects of a new stock exchange law*

Under the Basic Law, the federal legislator is responsible for competing legislation in the area of stock exchange law. As in past Stock Exchange Act amendments, the federal government will discuss the preliminary draft with the competent authorities of the *Länder* before the actual legislative procedure begins. Further consultative possibilities for the *Länder* are constitutionally guaranteed in the legislative procedure, so that their experience can flow into this legislative process.

Just as important as the technical and organisational modernisation of the German stock exchange structure is the recodifying and expansion of supervision of the stock exchange and the securities industry. Effective market supervision and a supervisory authority with international scope of action are today a mandatory feature of the quality seal on a financial market. The implementation of EC directives also necessitates that new supervisory powers be put in place which go beyond stock exchange supervision and cover wide areas of the securities industry. This includes notification requirements, transparency rules, "rules of conduct" for the fair treatment of investors and an effective insider trading law.

3. *Guidelines of the concept*

Against this background, the federal government will orientate itself according to the following guidelines in the currently pending amendment of stock exchange law:

- implementation in place of an efficient and unbureaucratic securities and stock exchange supervision compatible with international standards, in particular for the area of insider trading law;
- enhanced investor information and transparency of markets;
- introduction of internationally accepted notification requirements;
- creation of a level playing-field for floor trading and official currency brokers on the one side and the computerised exchange on the other;
- structural improvements through various measures for the promotion of market liquidity and attractiveness of stock.

V. *Implementation of the programme*

1. *German Financial Centre Act*

The programme will be implemented by means of an amending act to

the Stock Exchange Act, which will in effect be expanded into a securities trading act. Further, an amendment of the Capital Investment Companies Act is envisaged in order to give investment companies new financial instruments. The amendment will be designated as the "Second Financial Market Promotion Act" or "German Financial Centre Act". Adoption by the *Bundestag* is planned for the second half of 1992—in time for the completion of the internal market.

2. *Structure of future German stock exchange and securities supervision*

- a) The future structure of German stock exchange and securities supervision raises the following two issues:
- who is to be responsible for supervision in the stock exchange and securities industry
  - and
  - what content and scope such supervision will have.

Mere *legal* supervision of the stock exchanges, such as is currently exercised by the *Länder*, is no longer adequate. What is needed is a *market* supervision such as is normal practice in the major financial centres and has long existed in Germany in the banking and insurance industry. Market supervision in the stock exchange and securities industry goes well beyond legal supervision and combats weak points that are detrimental to the functioning of the markets and protection of investors. For this purpose, supervision must also cover wide areas outside the stock exchange, as becomes particularly clear in the implementation of EC insider trading directives and the EC publicity directive. The question whether and with what contents the EC securities services directive will be passed is one factor that will influence the scope of market supervision, as well as the powers of the competent authority.

- b) Market supervision must in any event be exercised by a central government agency endowed with the necessary powers of control and punishment and able to handle ever-growing worldwide cooperation with securities supervision authorities abroad. A federal authority has the advantage of having a uniform administrative practice and is, as a central body, in line with international standards. As early as 1990 the federal government, at the request of the *Länder*, took over the representation of German interests in the International Organisation of Securities Commissioners (IOSCO).

The currently existing supervisory duties of the *Länder* under the Stock Exchange Act, e.g. the legal supervision of the stock exchanges, remain unaffected. With a view to integrating these current functions in the supervisory model, the Federal Ministry of Finances has declared itself willing to hold discussions with the relevant *Länder*.

### 3. *Provision of insider trading law in line with international standards*

Current German insider trading regulation is inadequate owing to the voluntary nature of its recognition by the traders and its lack of enforceability. Here there is an urgent need for action. The following provisions are necessary:

- criminal liability in the event of insider infringements with the possibility of forfeiture of pecuniary advantages;
- legally enforceable investigatory, control and supervision powers for the competent authorities, as well as the power to take coercive measures;
- ongoing market control by the self-administering bodies of the stock exchange or a government agency;
- power to disclose information to the competent authorities within the EC and within the framework of international collaboration, subject to the principle of reciprocity and due respect for bank confidentiality.

### 4. *Implementation of various EC directives*

Beyond this, the following EC directives must be implemented as German law:

- securities services (if adopted in the EC);
- disclosure requirements relating to transactions involving significant holdings in listed companies.

These directives are also aimed at further enhancing transparency on the capital market, strengthening the rights of investors and regulating the conditions for professional participation in the stock exchange and securities business. With the implementation of the EC directives, a number of new situations subject to supervisory and notification requirements will be added. The incorporation of the securities services directive in the Financial Centre Act can be decided upon only when the negotiations in Brussels are concluded. It may be necessary for some parts to be adopted into German law on an anticipatory basis.

### 5. *Concept of a dual system of computerised and floor trading exchanges; structural improvements in stock exchange law*

- Introduction of the institution of “official” price fixing for computerised trading, under the responsibility of the stock exchange Board (amendment to § 29 of the Stock Exchanges Act);
- provision for investors to choose between settlement at a computerised or floor trading exchange;
- binding inclusion of representatives of institutional investors in the managerial bodies of the exchanges, and balanced representation of all groups in the committees of the stock exchange Board;
- improvement of prospectus liability.

6. *Miscellaneous structural improvements*

a) *Amendments to the Investment Companies Act*

- admission of genuine money market funds, enabling investment companies to make a complete investment with liquid money;
- admission of security-based loans, reinforcing the functional capacity of the domestic market for security-based loans through development of the lending potential of German investment funds;
- admission of debenture-based loans for special investment assets.

b) *Amendment of the Deposits Act*

Annulment of the reciprocity clause under § 5 (4) para. 4 of the Deposits Act for the enhancement of giro securities transactions with foreign countries.