

Theory of Securities Market Integration: Lessons from the European Union

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Abstract: European economic integration, in particular securities market integration, is based on Scitovsky's theory that the integration can place through 'the abolition of restrictions on the movement of products and, on the movement of labour and capital.' The restrictions were of three types, namely physical, fiscal and technical differences among the European nations. Of them, the technical barriers included conflicting legal requirements. To remove this, the European Community (predecessor of the European Union) adopted a dual method of integration, namely harmonization of legal provisions and standards, and mutual recognition of the rest of the matters across the border that was not possible to harmonize. This theory and technique of integration has succeeded in Europe. This paper proposes this as a model for the integration of other regional securities markets including the ASEAN and SAARC.

Keywords: Securities market integration, European Union.

1. Introduction

1.1 Theory of Market Integration in General

In the European Union (formerly European Community), the single market, in general, and single securities market, in particular, seem to be based on economic integration theory propounded by Scitovsky.ⁱ According to him European economic integration can take place through 'the abolition of restrictions on the movement of products and, ...on the movement of labour and capital.'ⁱⁱ This would generate competition among the national economies of the Member States under equal conditions. Such competition may produce 'unfavourable effects' on any particular sector of any national economy. For example, small business firms that a particular Member State had been fostering with subsidy, even to the disadvantage of the big ones, may not survive the competition.ⁱⁱⁱ In such a situation Scitovsky suggests for adopting measures to remove the 'unfavourable effects' or to convert them into 'favourable ones' and thereby to bolster the integrated market.^{iv} On the similar line

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of hypothesis, the European Commission sought to completely establish the integrated single market free from ‘barriers of all kinds’^v. In doing so it, of course, it was recognised that ‘many of the changes ... will present considerable difficulties for Member States and time will be needed for the necessary adjustments to be made.’^{vi} As to why such adjustments should be made the Commission maintains that,

The benefits of an integrated community economy of the large, expanding and flexible market are so great that they should not be denied to its citizens because of difficulties faced by individual Member States. These difficulties must be recognised, to some degree they must be accommodated, but they should not be allowed permanently to frustrate the achievement of the greater progress, the greater prosperity and the higher level of employment that economic integration can bring to the Community.^{vii}

2. Barriers to and Tools of the EU Market Integration

Now, what are the barriers to the establishment of the integrated market? How can they be overturned? The Commission identified three kinds of barriers: (a) physical barriers, e.g., national customs posts; (b) fiscal (or taxation) barriers; and (c) technical barriers.^{viii} Of these the last category was ‘most extensive and included all national measures that restricted market access for non-domestic products,’^{ix} for example, ‘different standards for individual products adopted in different Member States for health or safety reason or for environmental or consumer protection.’^x With regard to capital and financial market, the technical barriers refer to different ‘regulatory and prudential standards applied in particular to operators and providers of services’.^{xi} However, in order to eliminate the barriers, the Commission moved away from its erstwhile only-harmonisation approach to an amphibious approach of harmonisation and mutual recognition. The reason behind was that despite ‘unprecedented progress’ by 1985, harmonisation had a number of shortcomings, e.g., detailing technical specifications which was subject to unanimity in the Council caused much delay.^{xii} As well, relying solely on harmonisation would have been ‘over-regulatory’.^{xiii} On the other hand, resorting to only-mutual recognition would have been insufficient given the increasing size of the competitive market of Europe.^{xiv}

At this point, it is relevant to focus on the nature and function of harmonisation and mutual recognition with regard to market integration. As observed above, the internal market programme aimed at establishing a market *without* frontiers. In other

words, the intended market would look like a domestic market where goods and related production factors (person, capital and services) could freely move. But the Member States, with a variety of diversities^{xv}, had different legal and administrative requirements, e.g., varying standards for products, qualifications for professionals and regulations for services. These differing requirements stood in the way of the free movement of goods, people, services and capital (called four freedoms). Therefore, there was a need of laying down essential requirements instead of detailed ones so that the Member States could incorporate them in the domestic laws or amend necessary legal provisions. In this way harmonisation has been achieved.^{xvi} The means of harmonisation was and is EC Directives issued by the Council under Article 94 (ex-Article 100a) of the EC Treaty. The member states are supposed to adopt means to comply with the Directives. The means adopted by the states to implement the directives within the national jurisdictions may differ, but the ends are the same.^{xvii}

3. Integration Theory of the EU Securities Market

As far as the securities market is concerned, through this method of integration (harmonisation of national laws and rules), ‘the securities ‘issuers can be certain of the results in each participating country, but may still have to comply with various sets of rules’.^{xviii} However, derogation from the harmonisation provision may be available to a Member State on certain grounds like health, safety, environmental protection etc.^{xix} Member States are allowed to legislate in such cases with varying standards or regulations.^{xx}

In the areas where harmonisation of technical standards or regulations is not essential from health, safety and other well-defined grounds, law requires, for the purpose of market integration, ‘recognition by a state of the validity on its own territory of rules made by one or more other states’.^{xxi} This is known as the principle of mutual recognition, which was first established by the European Court of Justice (ECJ) in the famous case of *Cassis de Dijon*.^{xxii} In this case the plaintiff importing French wine, Cassis de Dijon, with alcohol content of 15%-20%, was barred by the concerned German authority on the ground that it had to contain a minimum alcohol content of 25% as provided for by German law. It was contended that in absence of common rules German prohibition amounted to a quantitative restriction to free movement of goods within the Community according to Art. 30 (present Art. 28) of the EC Treaty. The ECJ upheld the contention. It said that it could have been accepted if it were necessary ‘to satisfy mandatory requirements relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer.’^{xxiii} In

other words, the Court for the first time established that in absence of harmonised Community law goods produced and marketed legally in a Member State must be recognised in other Member States unless it contravenes mandatory requirements rules.^{xxiv}

Apropos securities law, the basic purpose of mutual recognition of national requirements/rules in the EU Member States is ‘to keep the amount of supplemental information as small as possible.’^{xxv} If the issuers’ home country administration reviews the necessary documents, that will do; they need not experience regulatory hassles in other jurisdictions.^{xxvi} The method operates in a dual fashion: removing barriers to intra-Community market, and setting common standards.^{xxvii} For example, in the financial services area,^{xxviii} each Member State (host State) has to allow the financial services providers based in other Member State(s) (home State) free entry to its market subject to the condition that a minimum degree of protection for the investors or creditors is offered under the regulatory regime of the base country.^{xxix} Secondly, the EU issues Directives/Regulations setting common minimum standards are mutually recognised by both the home State and host State(s).^{xxx} In absence of such EU legislation the national laws of the Member States are applicable. It means the application of mutual recognition principle is not automatic, it requires EU legislative measures.^{xxxi}

4. Conclusion

As learned from the integration theory above, every country has its own securities regulation law and system. Integrating two or more markets must give rise to a host of technical and non-technical barriers in the same fashion as EU experienced. The EU has set an example of how to overcome the obstacles successfully by using two methods of integration, namely harmonisation and mutual recognition. North America (US and Canada) has followed the same theoretical path for integrating their securities markets and has, by now, established the Multijurisdictional Disclosure System (MJDS) between them. In the same way, any other region like ASEAN and SAARC may borrow the theoretical solution and bring about an integration of their securities markets practically introducing the tools of harmonisation of national rules as much as possible and mutual recognition of the unharmonised rules in the national jurisdictions.

References

- i. Geoffrey Fitchew, 'Political Choices: Report' in Richard M. Buxbaum *et al* (ed.), *European Business Law- Legal and Economic Analyses on Integration and Harmonization* (Berlin, New York: Walter de Gruyter, 1991) pp. 1-34, at p. 4. B. For economic integration theory in general and without particular reference to Europe, see Bela Balassa, *The Theory of Economic Integration* (London: George Allen & Urwin Ltd., 1962).
- ii. Tibor Scitovsky, 'Economic theory and Western European integration', (1958) 16 *Stanford Studies in History Economics and Political Science* 15 at p. 16.
- iii. *Ibid.* at p. 134.
- iv. *Ibid.* at p. 16.
- v. *Completing the Internal Market: White Paper from the Commission to the European Council*, COM (85) 310 final 1 (14 June 1985). at p. 4 (hereafter White Paper).
- vi. *Ibid.* at p. 7.
- vii. *Ibid.*
- viii. *Ibid.*
- ix. European Communities, *The European Union Encyclopaedia and Directory 1999* (London: Europa Publication Ltd., 1999) at p. 140.
- x. *Ibid.* at p. 6.
- xi. Geoffrey Fitchew, 'Political Choices: Report' in Richard M. Buxbaum *et al* (ed.), *European Business Law- Legal and Economic Analyses on Integration and Harmonization* (Berlin, New York: Walter de Gruyter, 1991) pp. 1-34, at p. 4.B.
- xii. White Paper, *supra* note 5, at pp. 18-19.
- xiii. *Ibid.* at p. 18.
- xiv. *Ibid.*
- xv. The EC member states have a variety of diversities with regard to language, legal system, economic strength, and geographical size and position and so on. In spite of this, they sought cohesion based on the common economic and political goals. This is unique of the integration process of Europe. To quote Schoutete, 'In reality, the entire European integration process is marked by a dialectical relationship between the necessary cohesion of the Union and the equally necessary diversity of the parts.' : Philippe de Schoutete, *The Case for Europe- Unity, Diversity, and Democracy in the European Union*, (London: Lynne Rienner Publishers, 2000), at p. 64. Both cohesion and diversity are "necessary" and neither of them can be undermined at the cost of the other, otherwise that will prompt 'a contrary reaction'. :Schoutete, above. In the integration process, the diversities and cohesion go hand in hand.
- xvi. Gondrand, *Eurospeak, A User's Guide: The Dictionary of the Single Market* (London: Nicholas Brealey Publishing, 1992), at 158.
- xvii. See David Johnson and Kathleen Doyle Rockwell, *Canadian Securities Regulation*, (Toronto and Vancouver: Butterworths, 1998), at p. 314.
- xviii. *Ibid.*
- xix. EC Treaty, art. 95 (old art. 100a).
- xx. *Ibid.* These varying standards are possible to be mutually recognised by the Member States. This has encouraged innovation at national level and at the same time integration at the Community level. For a detailed discussion on this issue, see Stephen Weatherill, *Beyond Preemption? Shared Competence and Constitutional Change in the European Community* in David Keefee and Patrick Twomey (ed.), *Legal Issues of the Maastricht Treaty* (London, New York, Chichester, Brisbane, Toronto and Singapore: Wiley Chancery Law, 1994) 13-33. At one place in this article, he wrote, 'In casting aside total harmonization as a model which cannot reflect

- the diversity of interests in the modern Community, one is welcoming flexibility and innovation and enshrining greater sensitivity to national preferences.’ at p. 22.
- xxi. Gondrand, *Eurospeak*, *supra* note 16, at p. 196. Also see See David Johnson and Kathleen Doyle Rockwell, *Canadian Securities Regulation*, (Toronto and Vancouver: Butterworths, 1998), at 316. After the European Communities had adopted mutual recognition as a method of economic integration to remove technical barriers, it ‘has played a leading role in the process of European integration, in particular, promoting the free movement of goods, services and persons’. Den-Chin Horng, ‘The principle of mutual recognition: the European Union’s practice and development’, (1999) 22(2) *World Competition*. 135 at p. 153. The principle has also become popular with other regions and at the international plane. In this regard, see John Clarke, ‘Mutual recognition agreements’ (1996) 2(2) *International Trade Law Review* 31 at p. 35. Behind such large scale acceptance principally lies the following rationale: Mutual recognition is perceived as a simple, low-cost and low-maintenance mechanism for overcoming regulatory impediments to trade. It also represents a cost-effective alternative to harmonisation of regulations and standards. While harmonisation requires costly and time-consuming negotiation among nations to achieve a consensus on mutually acceptable standards, mutual recognition achieves a similar effect more rapidly and without the associated costs.
- : Quentin Hay, ‘Trans-Tasmania mutual recognition: A new dimension in Australia-New Zealand Legal Relations’ (1997) 3(1) *International Trade Law Review* 6 at p. 6.
- xxii. *Rewe Bundesmonopolverwaltung für Branntwein (Cassis de Dijon)*, case 120/78, [1979] ECR 649.
- xxiii. *Ibid.* at p. 662.
- xxiv. *Ibid.*, at p. 664. The *Cassis de Dijon* formula is an invention by the ECJ with a view to keeping atop the objective of common market as enshrined in the EC Treaty. The formula is not found in the Treaty. The Court has just filled up the gap.: Stephen Weatherill, *Law and Integration in the European Union* (Oxford: Clarendon Press, 1995), at p. 236. Of course the “seeds” of the *Cassis de Dijon* formula was sown five years ago in *Dassonville*, case 8/74, *European Court Report* 837.
- xxv. Manuel Lorenz, ‘EC Law and Other problems in Applying the SEC Proposal on Multinational Offerings to the UK’, 21(3) *International Lawyer* 795, at p. 819.
- xxvi. Johnston and Rockwell, *supra* 17, at 316 n. 79.
- xxvii. Gerard Hertig, ‘Regulatory competition for EU financial services’, (2000) 3(2) *Journal of International Economic Law* 349 at 352.
- xxviii. For difficulties associated with harmonization policy, and the merits of mutual recognition and minimum harmonization in the field of financial services law, see Wulf-Henning Roth, ‘The European Community’s law of services: harmonisation’, (1988) 25 *Common Market Law Review* 35 at pp. 84-94.
- xxix. Gerard Hertig, ‘Regulatory competition for EU financial services’, (2000) 3(2) *Journal of International Economic Law* 349, at p. 353. (footnote omitted).
- xxx. Mr. Monti, ‘Problems in applying the principle of mutual recognition’, (1995) *Official Journal* C222/41 at 42.
- xxxi. *Colegio Oficial de Agentes de la Propiedad Inmobiliaria v Aguirre Newman SA*, case 104/91, [1992] *European Court Report* I-3003, at p. 3007.