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Widen the market, narrow the competition : the emergence of supranational governance in EU capital markets

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CHAPTER 8: RENEGOTIATING THE ISD IN THE SUPRANATIONAL CONSTELLATION

The introduction of the Lamfalussy process was only one side of the institutional changes that marked the transition of capital market policy in Europe from the 'international' constellation to the transnational one. In addition to the adaptation of formal governance structures, state-market relations in the capital markets domain have assumed a transnational character. The industry is now largely organized on a European basis and uses regional trade associations to assert its preferences in the policy process. 'Brussels' has emerged as the focal point of lobbying and decision making. The degree to which public-private interactions have been institutionalized at this level is evidence of a (temporary) 'equilibrium' between new supranational patterns of governance and the transnational scope of market structures. The first half of this chapter shows just how far this process has evolved.

The chapter's second half analyses the regulatory changes that have largely completed the cross-border market integration that began two decades earlier. With implementation scheduled for late 2007, the Markets in Financial Instruments Directive (MiFID) has replaced the ISD. This chapter traces the process from the Commission's initial proposals in 2000 to the MiFID's endorsement by the Council and the European Parliament in 2004. This case study of 'Lamfalussy in action' illustrates how the political climate has shifted from a preference for nationally idiosyncratic regulatory regimes towards supranational harmonization. ISD negotiations had been hampered by the divergent interests of national financial industries, in particular their protectionist impulses. MiFID negotiations, in contrast, featured competition between regulated exchanges and large investment banks. To be sure, both camps favoured cross-border market integration. But they disagreed on the terms under which investment banks would be allowed to act as market-makers in competition with securities exchanges. This resulted in negotiations that were even more drawn out than the original ones for the ISD. MiFID

negotiations showed that competition politics had anything but disappeared with the cross-border integration of the industry. They had become properly transnational.

This new competitive constellation, which structured negotiations and shaped regulatory outcomes, is a good example of the structuration process at work within EU capital market integration: the consequences of strategic decisions made by the banks a decade earlier now informed competition between investment banks and regulated exchanges. When the banks ‘demutualized’ the exchanges—turning them into independent for-profit entities—they created a new kind of actor in European financial markets. Regulatory politics after 2000 can only be understood against the background of the earlier strategic restructuring of the financial industry and the corresponding shifts in preferences. The chain of events in which core actors set the stage for each following integration step cuts across ‘states’ and ‘markets’.

The supranationalization of EU capital market governance does not mean, however, that contemporary patterns of governance determine regulatory outcomes—competition politics does. There is one important area where the EU still has no competencies: clearing and settlement. The fragmentation of the industry in this sector is widely seen as a major impediment to the kind of market integration envisioned by the European Commission. As before, appeals to wider economic goals were insufficient to sway governments in favour of EU level action. Instead, the clashing competitive interests of a small number of firms prompted their respective governments to veto the further supranationalization of policy-making. Given incompatible competitive interests, Internal Market Commissioner Charlie McCreevy was forced to admit defeat in 2005, announcing the Commission would abstain from proposing a directive for the sector. Competition politics still trump where interests remain opposed to the pull of massive institutional change.

European lobbying transformed

The flipside of the formal and informal institutionalization of supranational governance has been a shift in the way private actors interact with public policymakers. This process began in the mid-

1990s as private actors' preferences swung in favour of transnational market integration and supranational governance. They opened lobbying offices in Brussels and began cooperating on a European level. Over time, the Europeanization of public-private interaction in capital market policy was driven by the mutual reinforcement of the supply of EU-level policy input and the demand for it that evolved as supranational institutions grew stronger. This is a prime example of structuration at work: the growing relevance of EU bodies demanding input from supranational trade associations is itself a function of the growing market-integration preferences within the industry. In this way, Streeck and Schmitter's (1981) logic of access and logic of membership in the structuring of private sector input into public policy are two sides of the same coin—even if other factors also play a role, their co-evolution is plain to see.

In capital market governance, these two 'logics' have been expressed in the growing transnational organization of business interests and the formalization of public-private relations at the supranational level (cf. Streeck and Schmitter 1991, Cowles 2001). Taken together, these two trends show how after a decade of transformation, private-public associative patterns have stabilized again. As if in a new 'equilibrium', the scope of investment banking markets, political institutions and private-public interactions complement each other in the 'supranational constellation'.

To begin with, the European scope of much of the legislation imposes a new focus on formerly nationally oriented lobbyists. One representative of a City association found that:

[w]hen I arrived here [at the association in 2000] I probably spent 10 per cent of my time on international issues, of which 9 was on Europe and one for the rest of the world. By the time I gave up last year [2005], the figure was probably 80:20, 80 per cent international, 20 per cent domestic. That partially reflects the fact that domestic matters were becoming more routine and we got the full flood of European measures. (Interview 300306)

The growing relevance of EU level measures led to more lobbying in Brussels, though lobbyists from individual firms tried to avoid acting on their own (Interview 231105). Instead they sought

the broadest possible consensus—if possible through some EU-level association—and then tried to insert their own preferences.

People [lobbyists] know each other's positions. In Brussels they play with open cards. [A Commission official] has enough to coordinate already. What is important for him is that he does not have seven people from different banks come to him with the same message on the same day. So everybody, also the Commission, plays very open. People ask 'Listen, this is my position.' If you have one, that is. 'What is yours?' And then people will be very honest. 'On this issue, we cannot follow you because we have a different business position, different business interests.' Or maybe you even say 'Our opinions are diametrically opposed here.' That was the case for example with the Capital Adequacy Directive between the savings banks and the private banks. But of course, that weakens the voice of the banks as a whole. And where the industry does not speak with one voice, the room for manoeuvre of politics increases. I don't think... It is not impossible, but it is of course more difficult for the Commission and later for the [European] Parliament to push through a proposal that is rejected by all [banks] across the board. (Interview 231105)

Finding such broad industry consensus can be a laborious process, well-illustrated in an example given by Mijs and Caparrós Puebla (2002: 265ff). As already mentioned, one of FESCO's main achievements was agreement on a common definition for professional and retail investors (Federation of European Securities Commissions 2000). The original definition it proposed fell short of what industry had hoped for: only financial institutions could be professional investors. Even large non-financial corporations fell into the 'retail' category, meaning host country conduct of business rules applied (Interview 270206). In response to FESCO's proposal, ABN AMRO prepared a classification of its own to submit to the European institutions. It presented the proposal to the International Swaps and Derivatives Association (ISDA), LIBA and the EBF, but found getting their approval more difficult than anticipated.

Even if the primary goal was to obtain broad support for our alternative [classification], even in an amended version, from associations, time was running fast and further pressure on FESCO was needed. We therefore decided to engage, parallel to our discussions with associations, in

negotiations with other European banks where decisions could be made in a speedier way. (Mijs and Caparrós Puebla 2002: 266)

Again, this took more time than ABN AMRO imagined. Because of the level of detail, each bank had to consult internally on whether the relevant business units ‘could work under the terms proposed’.

In July 2001, eight leading European banks agreed a joint paper proposing to FESCO and to the European Commission an alternative classification. [...] At the same time, the [EBF] had successfully convinced all its national associations of the merits of proposing an alternative definition of professional investor and was discussing in detail our joint paper. The [EBF] finally agreed to send the joint proposal, agreed by eight leading banks and its national associations, to the European Commission and to FESCO in July 2001. (Ibid.: 266f)

Using consensus among core players to get whole associations on board could also work the other way around, with the urgency coming from EU bodies rather than industry. One lobbyist gave the example of the Single Euro Payments Area (SEPA), a favourite Commission project due to its (hoped for) visibility for EU citizens (see e.g. European Commission 2008):

Let’s assume that Commission really wants a single European payments area. Then it says: ‘We want that.’ Then the industry says: ‘Hm. That’s difficult, that is going to be expensive.’ Then the Commission says: ‘Yes, but you do have to move a little [on this issue].’ Then the industry says: ‘Okay. We all get together and we build a sort of interest association where we discuss this. That is the European Payment Council, EPC.’ Then every now and then the [European] central bank or McCreevy [Commissioner for the Internal Market at the time] tells you: ‘Now, you should hurry up, otherwise we come with a regulation.’ And then you maybe realize: ‘Oh, now there are very, very many players in the EPC.’ There is no real movement. That means, maybe they are doing good work where they agree technical standards but in essence, they cannot cut the Gordian knot. At that moment it is of course attractive for the Commission to talk, not with us, but possibly our board members and to say ‘Now, you guys have contacts to the other large banks. [...] You are the large players. How do you see all this? What should we believe of these things that we are being told? Where do you see the problems?’ And then it could possibly happen that several large banks say: ‘Well, in principle we understand where all this is going but here and there, there are simply insurmountable obstacles. But if it is really the case that either

we get a regulation or we move some, then this is how far we can go.’
And if then you can tell the Commission: ‘We have the largest twenty
players,’ or even only the ten largest players in Europe behind such a
proposal, then the chance that such an EPC will agree to such an
informally agreed thing is of course much larger. Now that is the game.
(Interview 231105, authors translation from German)

In addition to collective action problems, the overlap of commercial interests among the members of an association such as the EBF are crucial in determining its ability to act: on the issue of internalization—central in MiFID negotiations and discussed in more detail below—the interests of European banks diverged (Interview 211105.b). In contrast, the EBF was effective in generating consensus on the Market Abuse and Prospectus Directives:

Prospectus is an example. I know that going into the Council meeting people have told me that they could see that the EBF position paper was on the desks—not on every desk—but a whole range of governments were using that as an element of their briefing. And you are aware that in the prospectus directive, the whole approach completely switched around, and that was the result of an awful lot of lobbying that was given the parliament. Particularly on the fixed income side. The EBF, with IPMA—lobbying from a more London perspective—put in very substantial amendments and lobbying points. (Interview 140306.b)

The demand for EU-level private sector input has led to the creation of many new bodies and associations that complete the supranational organization of industry interests. In contrast to old national corporatist associations, they are either forums for consensus-finding or single-issue associations. The European Payments Council is a good example of the former, as is the European Banking Industry Committee (EBIC), the most encompassing trade association in EU banking. The latter was launched in January 2004 (European Banking Industry Committee 2004) in response to the Commission’s desire to hear from ‘the industry’ in a single voice. Unsurprisingly, the range of issues on which there is sector-wide agreement is relatively limited; most of its output therefore tends to be framed in rather general terms. At the same time, that the EBIC exists at all says much about the consolidation of interest representation structures at the European level.

The European Securities Forum (ESF), also set up in 2004, is one of the more prominent single-issue associations in EU capital markets. It pushes for consolidation in the clearing and settlement industry (Interview 220206). The interests of the investment banks are divided on this issue; the French banks, BNP Paribas in particular, have commercial stakes in the continued fragmentation of the clearing and settlement market. The ESF thus brings together the major investment banks active in Europe save the French ones.⁴² It exemplifies the new geometry of interest representation where loyalties and shared background play less of a role than commercial interests. Rather than being channels for top-down communication, ad-hoc interest associations such as the ESF are used instrumentally by shifting alliances of market participants. They complete the spectrum of private EU-level sector associations that meet the public sector demand for policy input.

In addition to the field's Europeanization, the second major trend in EU capital market lobbying has been the formalization of industry ties with the Commission, CESR and the EP. This mainly comes in the form of regular public consultations and fixed-membership 'advisory groups'. The formalization of public-private relations largely reflects the desire of firms to be heard and informed at all stages of the policy process.

[T]here was a problem before because [...] it took ages to have a directive adopted and then when it had to be implemented it was already outdated. That was something that everybody recognized. And when Lamfalussy was created, we were still really supportive of that. It is a good thing to have a EU culture in supervising. By working together, they are forced to develop common interpretations, common guidelines, common advice to the Commission. I think [our bank] is one of the few lobbying offices where we really were strong in [replying to] nearly all CESR and CEBS [Committee of European Banking Supervisors] consultations. On MiFID, we have one person working on MiFID, level 2 [of the Lamfalussy process]. So CESR consultations. For CEBS consultation, we did not respond directly, we gave our input to [the EBF]. Yes, it is a lot of work but it is what we have been asking for. So

⁴² ESF, 'Members', As accessed on 19 May 2004 under <http://www.eurosf.com>

we have to be consistent. It is much more transparent than before.
(Interview 211105.b)

The opportunity for input that CESR offers is indeed considerable. In 2007 it launched no less than 21 consultations, normally in the form of highly technical documents published on its website. 'Interested parties' were then invited to comment. As these documents are usually long, formulating appropriate responses that reflect corporate interests is a full-time job. It is thus hardly surprising that responses only come from the financial industry, non-financial issuers of securities and supervisory bodies. Nevertheless, for large investment banks with transnational operations, having CESR produce countless consultations is preferable to monitoring the proceedings of more than a dozen national regulators (Interview 070406). As one lobbyist observed,

[t]he industry demand was also more consultation, more transparency. And CESR has given it to them in bucket loads. There is so much consultation. Also, the CESR members are closer to the industry than to the Commission. In that sense, the industry is quite pleased. Of course, sometimes CESR comes up with rules that are more detailed than the industry thinks are necessary. (Interview 021205.a)

The degree of detail in common rules, another industry representative found, was partially the fault of the industry itself:

So we are talking not only about the framework, but MEPs who are beleaguered by firms and lobbyists, who arrange things down to the smallest technical detail for very different motives. There are for example people who come here and complain that the Commission makes such complicated laws. On the other hand, they come here to try to get things into the directive, because they don't want their supervisor at home to have too much leeway. They try to arrange things here in Brussels so they don't have to arrange them in England or in Germany. (Interview 231105, authors translation from German)

For another industry representative, EU-level rule harmonization was part of the overall shift in capital market governance:

[T]hat is the price you pay for increasing recognition. The price is everybody levels up. Now as it happens, for the big firms, it probably

doesn't matter too much. Because they were already pretty levelled up anyway. If you give them cross-border access, that is a price they are willing to pay. This is a huge political problem for the 99 per cent of banks who are domestically active and will have to pay the price, too. You will see in the next two years a huge outcry from retail banks [...]. The stockbrokers—why should they have to do all this? They don't trade across borders. It's all for the price of the big firms. The other part of the deal is the Lamfalussy process. He said that there should be mutual recognition based on trust. It hasn't so far delivered. We were in favour of mutual recognition and competition but the member states would not buy it without massive harmonization. So you get a much more detailed framework. That on the whole is working. The deal there is [...] we got the transparency. Because our only chance really was to stop the regulators stitching us up in private and imposing... So we desperately wanted public accountability and EP accountability. Some of the bizarre things you have seen in the FSAP is the industry supporting the EP which is not always very reliable. Supporting transparency in the Commission. The Commission did not like it at first. It is still slightly uncomfortable with the length of time it takes to go through this transparency process. And to be fair to CESR, Fabrice [Demarigny, secretary-general of CESR] did a great job. They really do now operate in a transparent manner—and they did not like it in the beginning. (Interview 270206)

At the time of writing, most battles over consultation and representation have already been fought. All public bodies hold regular hearings and have their expert groups; the majority of these external 'experts' are industry representatives. The membership list of the European Securities Markets Expert Group (ESME), the official advisory committee to the Commission, is instructive: all of its 20 members come from financial firms (European Commission 2006b). As expertise is defined in technical terms—and the problem to be solved is nothing less than the optimization of capital markets—the Commission finds the group representative. Other formal 'advisory groups' to the Commission and CESR have similar compositions. For example, only one out of the 26 member of the Securities Markets Expert Group which evaluated progress in market integration and legal harmonization was not directly or indirectly an industry representative.

The influence of these groups of 'experts' should not be underestimated. According to

ESME, they should provide ‘technical advice [...] on issues of contemporary relevance in EU securities markets’ (European Commission 2006a). This included credit rating agencies (CRAs), in the public spotlight since the summer of 2007. In August, the Commission publicly questioned their role in the credit market crisis that spread out of the US housing market (Buck 2007). Two years earlier, however, heavy lobbying from industry had deterred the Commission from attempting to regulate CRAs (The Banker 2004). The seemingly ‘technical’ can rapidly assume highly political proportions.

On the whole, then, lobbying has come a long way since the early 1990s (Interview 070406).

Back in the days, you could go and lobby the Commission fairly directly, and that was that. Now you have to lobby CESR, the individual member states, the EP. On the one hand, you have a lot more opportunity to lobby, on the other hand, you need to do it well, there is a lot more you have to do. That is one change to ten years ago. Back then, you basically just went to the person on the Commission who was writing the directive. And you succeeded or you failed. But you knew there was one person or a couple of people dealing with this. And the parliament only advised... (Interview 021205.a)

With the multiplication of relevant actors, the frequency of interactions has increased. A lobbyist from a large US investment bank estimated that his firm talked to the Commission ‘basically every week’ (Interview 070406). Sometimes ‘Brussels’ calls on its own—something he claimed was unthinkable a decade earlier.

It brings the EU more towards the US level of legislation. More lobbying. More PR. Government relations work. The whole thing becomes much more professional. Back then it was much more informal, behind closed doors. That is gone. (Interview 021205.a)

Within the architecture of European public-private relations, the role of the European Parliament has grown over the past decade, even if the Commission still stands at the centre of Brussels lobbying (Interview 211105.b). This reflects its increased powers since the Amsterdam

Treaty. MEPs are also popular targets for lobbyists; the other EU bodies can draw on more in-house expertise than MEPs, making them susceptible to external influence:

The MEPs, their main problem is lack of resources, but they want to be seen to be active. So they are quite keen to meet people. You state the case and present your argument. It is still very much how good an argument you can come up with. You sometimes still end up with some maladroit lobbying where you have four or five MEPs putting forward exactly the same kind of amendment [to a Commission directive proposal] in the same language. (Interview 021205.a)

The more experienced parliamentarians are aware of this vulnerability (Interview 071205.a, Interview 120106.b). However, lobbyists found manipulating MEPs can quickly tarnish their reputation and forfeit their most valuable asset: access to policy-making (Interview 011205). One MEP confided that he received so many invitations to London on the back of EU efforts to curb insider trading that he stopped accepting them altogether (Interview 071205.a). There are, then, unwritten rules about how far lobbyists can go. Nevertheless, MEPs in particular remain exposed to corporate influence; their lack of expertise makes them dependent on industry 'experts'. And given the vagueness of the overarching goals in capital market policy, the key is often to connect one's specific proposals to those general themes:

For some [MEPs], efficiency is the main thing. The next level is that this will create jobs. For some, you will need to link it to why this is good for your constituency. And in financial markets, the arguments are fairly straightforward. Who could really be against efficiency? You would have a much harder time if you came with a protectionist view. Then you would have to spin some sort of cultural argument. That this would destroy national tradition... But even on consumer protection, some of the more far-sighted firms understand that that is in their interest. They want happy, confident consumers. Otherwise, they are not going to sell anything across borders. (Interview 021205.a)

In sum, EU-level public-private interactions are starting to approach the level of routine that they had hitherto only had in national policy communities. The establishment of new transnational trade associations, fixed-membership 'expert' panels and formalized consultative procedures has completed the supranationalization of EU capital market governance. This novel pattern of

governance once more matches the effective scope of many core firms' business operations and of market structures in which a new group of market incumbents—a European 'Champions League'—has emerged in investment banking and securities trading.

Lamfalussy in action: Renegotiating the ISD

The renegotiation of the ISD, which led to the Markets in Financial Instruments Directive (MiFID), is a case study of the Lamfalussy process' implications for the governance of European capital markets. The MiFID is widely considered the most important directive for capital markets since the ISD, and probably the most important for European financial markets as a whole. Negotiations for the MiFID not only demonstrated the Lamfalussy process at work; the substantive rules contained in the directive also reflected stakeholders' changed preferences. The previous chapter showed how the interests of most large firms had coalesced around further cross-border integration of markets and governance, even if some were more enthusiastic about new legislation than others. Once it was decided that the directive was to be rewritten, discussions immediately shifted to the content of new legislation.

The fault lines in the discussions showed how much the competitive landscape and preferences had transformed over the preceding decade. Traditional, national protectionism on the part of banks and stock exchanges played only a minor role. Within these two groups of firms, competitive struggles remained subdued. Regulated exchanges with de facto monopolies over the on-exchange trading of their home market shares posed little threat to each other. Sporadic attempts to break into each other's markets—as the London Stock Exchange did with its offer to trade Dutch shares in 2003—invariably failed. Among the large investment banks, business models had grown sufficiently similar to make EU level regulation an ineffective tool for competitive struggle, because firms would be affected by regulatory changes in roughly similar ways.

This did not mean that competition politics had been superseded. One source of resistance to the large banks' preference for market integration—smaller firms—were too few in

number and too ineffectively organized to mount a significant defence. As chapter 5 showed, the number of firms holding significant market share in Europe was small to begin with.

Transnational market integration further put small brokerage houses in Paris, Frankfurt and London on the defensive; many were bought up (e.g. Augar 2000 for the UK, Jabko 2006 for France). Most other EU member states had no investment banking industry to speak of. In addition, the growing divergence between the interests of large and small firms weakened national alliances; the positions of national sectoral associations often remained vague or reflected larger firms' preferences. In short, smaller firms were too weak, both economically and politically, to counter the wave of regulatory harmonization about to sweep over them. As one Commission official concluded, forging agreement on a 'true' passport was helped both by the increasingly global nature of firms in the business and the fact that fewer and fewer of them remained (Interview 141205).

The real competitive struggle in negotiating the MiFID took place between stock exchanges and investment banks over share and bond trading: where was the future of European securities business going to lie? To understand the core issue it is useful to take a step back and consider the evolution of share trading over the previous decade. Historically, bourses functioned as clubs of brokers and market makers (R. Lee 1998, Braithwaite and Drahos 2000). As owners of the exchanges, member firms invariably pocketed any profits that accrued during share trading—whether through their own fees or those charged by the stock exchange. In addition, monopolies on the trading of domestic shares limited competition for trading services: as rulers of the bourse, market incumbents could control access to the business.

Chapter 5 recounted how stock exchanges demutualized over the course of the 1990s. Brokers turned members-only clubs into for-profit firms and sold them, often by listing on the same stock market (Steil 2002a). The new businesses quickly tried to secure as large a share as possible of the revenues associated with securities trading (trading revenues, but also listing fees, clearing and settlement fees, custody fees, etc.). This surprised the investment banks. One

investment banking lobbyist argued that two decades earlier, national exchanges had been

[o]ld boys clubs with a license to effectively print money, probably protected by law. Then, they were refusing to move with the times. They were very reluctant to set up sensible governance structures internally. They failed to get the right chief executives. And then people said ‘It can’t get much worse than it is now.’ But then, we [the investment banks] should have made sure that we had it right. [...] The banks themselves did not anticipate the speed with which the new management [of exchanges] would adopt profit-maximising instincts and apply them to their monopolistic position. (Interview 300306)

Demutualization thus gave a new competitive, political salience to the question of why securities markets should be organized around national exchanges. Investment banks felt they could perform many of their functions. For listing—effectively ‘vetting’ issuers of securities—and for clearing and settlement services, some central entity was desirable. But trading services could just as well be performed by investment banks as market makers. Trading could thus be ‘internalized’ by banks and bypass bourses altogether. It was clear that the old concentration rule would fall in renegotiating the ISD; securities trading on alternative venues would be enshrined in EU law. What remained undecided, however, was how high the bar for non-bourses would be set. Given the commercial stakes for both the stock exchanges and investment banks, ‘systemic internalization’ dominated the negotiations. A Commission official had no doubt on this point:

On MiFID, the real problem was internalization. Because it was about competition, and the competition was between stock exchanges and other forms of markets. That was really the main aspect. (Interview 141205)

The initial Commission proposal, discussed in the Forum Group on the ISD, placed the bar for systemic internalization relatively low. There had never been much doubt that trading data would eventually need to be aggregated at some central point to aid price formation and efficiency, and to allow effective supervision. The argument for market efficiency was hard to trump (cf. Jabko 2006); it was, after all, the official rationale for creating a single European capital market in the first place. Efficiency, however, said little about how information was to be

aggregated or about when such information would have to be communicated to a central authority. The details—and costs—of such ‘post-trade transparency’ were still up for grabs.

‘Pre-trade transparency’ was even thornier: the question of how systemic internalizers would ensure that their clients were receiving the best available price (Interview 021205.b). Given the enormous volume of securities traded each day, even tiny price differentials would generate significant profits for banks and, by implication, damage to their clients. At the same time, by endlessly complicating requirements to ‘shop around’ before matching two trades in-house, pre-trade transparency could be used to make systemic internalization altogether unattractive. Proposals went so far as to require brokers to tape all telephone calls with clients, which could then be used as evidence against investment banks in court.

Although the eventual rules did not include this obligation, investment banks were clearly surprised by the effectiveness of the stock exchanges in mobilizing political actors for their cause. The Federation of European Securities Exchanges (FESE) is widely credited with having played a central role. As its name suggests, it began as a ‘federation’ in the early 1990s. But its character changed over the following decade. As one investment banker observed, not without admiration:

FESE is no longer a club that has national monopolists as members. Rather, FESE is now a political association of financial services companies which are above all competitive. (Ibid., authors translation from German)

This did not mean that FESE’s members had identical interests. Depending on their own business model and home regulatory regime (cf. R. Lee 1998), some bourses were more intimidated by the prospect of systemic internalization than others. The application of the concentration rule, which forced share trading onto exchanges, was not required under the ISD: member states were free to apply it or not. Among the larger European markets, France and Italy had put it into effect. Thus shielded from competition, the Paris Bourse and Borsa Italiana in Milan had the most to lose from internalization. For them, the MiFID had the potential to, as one exchange lobbyist put it, ‘destroy the market’ (Interview 021205.b).

in MiFID terms, there is no question that the two key jurisdictions in terms of politically lobbying from a different perspective to that of the City were France and Italy. And the other key player in the politics of MiFID was FESE. Driven not just by concerns of, say, Euronext-LIFFE or, say, Borsa Italiana, but also by Deutsche Börse's concerns. (Interview 140306.b)

The Deutsche Börse, Germany's central stock exchange, was already functioning in a regulatory environment that permitted off-exchange trading. Trades through alternative channels were reported directly to public oversight authorities, meaning that off-exchange business completely bypassed Deutsche Börse. Investment banks and alternative trading venues such as Instinet were its direct competitors. While the MiFID was unlikely to heighten competition, it had the potential to increase the regulatory burden on off-exchange trading, and thus bring business back to the exchange (Interview 021205.b). Deutsche Börse therefore supported stringent pre-trade and post-trade requirements and, as one stock exchange lobbyist found, it 'could hide its own commercial interests rather well behind the investor protection argument' (Ibid., authors translation from German).

The London Stock Exchange was different again, largely due to the regulatory regime under which it operated. A remnant of the times of self-regulation, the LSE still functioned as the central authority through which trading data was aggregated and price information was provided back to banks and other trading venues. For this it charged its clients. Because London had known no concentration rule, the LSE had shifted its primary sources of revenue towards those functions where there was less competition than for trading services (Interview 130306). As with other exchanges, the LSE was not hostile to the idea of rules that would let it keep or regain liquidity (Interview 140306.b). But getting the London bourse to join most other FESE members in opposing internalization was no easy task Interview (021205.b).

This was the competitive constellation as the Commission drafted its legislative proposal. In many respects, the Commission was on the side of the investment banks and the 'City' model. The introduction of pan-European competition for trading services was its goal, and this meant

abolishing the exchanges' monopoly on the trading of securities and the tearing down of regulatory barriers. Investment banks were pleased with the early proposals. Yet national governments—particularly the French and Italian ones—together with FESE managed to tilt the Commission's text in favour of the exchanges. In a move that saw European capital market politics at its most dramatic, the Commission amended its legislative proposal on the MiFID the night before it was sent to the Council. It once again increased the burden of pre-trade transparency, a shift that was widely seen as a nod from the Italian Commission president Romano Prodi to the interests of his home government and Borsa Italiana (Ibid.). Investment banks were astonished; the MiFID had taken a very different direction from what it had seemed at the outset (Interview 231105). As one Commission official phrased it,

the idea of pre-trade came in last minute, just before the Commission finalized its proposal. It was actually... Some people say it was produced at the last minute. I suppose... That was not completely untrue, I would say. At some [earlier] points it was not there. (Interview 141205)

The interviewed officials working for DG Internal Market did not seem particularly happy with the last minute changes. But as 'bureaucrats' they had to follow the orders of politically chosen Commissioners. In this case, the 'national' loyalties of the Commissioners still seemed to trump commitment to the supranational project.

In the Council negotiations that followed, the banks found themselves fighting a rearguard action. The UK government still took what one representative called a 'City view' on the MiFID (Interview 120106.c), but with its strong pro-internalization stance, was alone among the larger member states. Whereas Deutsche Bank had bet on its contacts with policy-makers in Brussels, the Deutsche Börse relied on its connections with the national government; as mentioned earlier, it had not even set up a representative office in Brussels (Interview 240506.b). Though the German government did not take as strong a position as either the British or the French ones, it still came out in favour of pre- and post-trade transparency rules that were much more demanding than the investment banks had hoped for (Interview 231105). The big French

banks likewise had much less political capital with their national government than had been the case a decade earlier. A lobbyist for one of the large French banks felt that the French position on the pre-trade and post-trade issues was ‘nonsense’, based on ‘fantasy, not facts’ (Interview 160506.a). The French government, he argued, bore significant responsibility for many of the ‘bad’ things about the MiFID.

This disjuncture between large investment banks and their governments on the continent reflects the disembedding of national financial industries from what Hall and Soskice have called coordinated market economies (Hall and Soskice 2001a, cf. Story and Walter 1997). While most scholars agree that continental varieties of capitalism have not converged on an ‘Anglo-Saxon’ model (Schmidt 2002, 2003, cf. Glyn 2006), the role and positioning of their national financial industries certainly have changed—both in Germany (Vitols 2003, 2004) and in France (cf. e.g. Morin 2000, Clift 2004, Culpepper 2006). In both countries, the leading international banks have increasingly concentrated on their business and left their wider economic functions behind. The relevance of cross-shareholdings and the position of banks within them, for example, has clearly decreased since the mid-1990s. In a situation of competition with bourses, still closely wedded to national financial centres, investment banks could no longer count on their governments’ support to see their positions through in EU multi-level governance.

Instead, their hopes rested with the European Parliament to demand amendments that would soften the pre- and post-trade transparency requirements. But it took the banks some time to organize again, as one representative of a trade association remembers:

I would say we really started working quite effectively some time at the beginning of 2002. Already in 2001 we were starting to have meetings [...] different representatives of industry, banks, [EBF], all kinds of things, together, from the end of 2001 until the directive finally got adopted [...] More than a year, we organized a lot of meetings with presidencies, so each time there was a new presidency we would lobby them, we went to the Commission together, we wrote letters together, and most importantly of course we were able to convince the Parliament, and lots of different groups in the Parliament, as a whole [...] that in all those key areas the Commissions proposals had made the wrong decisions. [...] In

the end, a very good number of our suggestions ended up being proposed by the parliament. In the Parliament's second reading and then in the end, no, in between in the revised Commission proposals, because the Commission actually withdrew its proposal and actually [came out] with a new one. (Interview 221105)

One problem the banks faced was the number of firms standing to profit from internalization: less than a dozen. Uniting the European Banking Federation behind their interests was not going to be easy. Both the French and Italian national banking associations refused to sign up to the pro-internalization line, even if the largest French banks were now in favour (Interview 140306.b). The recalcitrance of the associations restrained the EBF in the statements it could make on behalf of the European commercial banks. With hindsight, another banking lobbyist felt the inability to present a unified position was a missed opportunity:

We were too late dealing with certain conceptual aspects. Had we started hard on the best execution [a central aspect of pre-trade transparency] right at the beginning, there would have been much more of a chance to get the intermediaries largely to agree. But the design [of EU rules] had gone far too far by the time we got in. [...] We started talking seriously, with the French [associations] particularly, in 2002, 2003, but that was too late, already. But it's a question of personalities. We wouldn't have talked to the right person if we would have tried earlier because he wasn't there. The French have gone through a large temperamental change in recent years. The boss of the AFEI [the French association of investment firms] has long despaired over his own government's inward-looking, protectionist philosophy. He says. 'We must compete, otherwise we will wither all.' But he doesn't control the system. The Trésor, the Banque de France, the big commercial interests don't always agree [with each other]. (Interview 300306)

The compromise that emerged from the co-decision procedure between Council and the European Parliament smoothed the rough edges of the transparency requirements. The competitive struggle between the investment banks and the exchanges ended without clear victors, even as observers were clearly impressed by the political defence the exchanges had managed to muster. In any case, as a banking analyst summarized, 'the margin of benefit of being a systemic internalizer has been significantly eroded, it would appear' (Interview 140306.b).

Another lobbyist for a large European bank concluded:

For us the MiFID is not really [a great business opportunity]. That is simply the way it is. For us it is, if you are really mean, we're speaking among ourselves, for us the only advantage is, that the small brokerage houses will suffer much more under the new rules and this transparency with best execution because in relation to turnover and profit the investment expenses are higher for them. (Interview 231105, translated from German by the author)

The implementing measures for the MiFID were only published in early 2006 (Buck 2006) so at the time of researching for this thesis, respondents were in no position to comment on the result. Nevertheless, almost a dozen London-based trade associations—including the London Investment Banking Association—had already launched a project called 'MiFID Connect' to develop industry standards for an even implementation of the new rules and to forge a consensus among firms on how MiFID provisions should be interpreted, especially in dealings between financial firms (Interview 140306.b). Where European regulators were bound to stop at the development of harmonized rules, the industry stood ready to take the baton.

The MiFID's consequences for markets and industry structure remain uncertain. Though tough transparency requirements may have lowered banks' profit margins in internalization, they will in all likelihood work to the advantage of the largest banks. The investments necessary to make the MiFID work are considerable, and beyond the means of many smaller firms. Nevertheless, most of the large banks have opted for caution and cooperate rather than compete in the challenge they mount to stock exchanges. The five largest brokers in Europe—bringing together more than 50 per cent of the securities brokerage market—have joined forces to set up a common trading platform, dubbed Project Turquoise (Cohen and Gangahar 2007, Tett 2007). With this members-only exchange, brokers have come full circle: having dismantled national share trading clubs in the 1990s wave of demutualization, they have reverted to the old model of user-owned exchanges—only this time on a transnational plane.

Clearing and settlement: the persistence of national competition politics

One crucial area within European capital markets has so far remained largely untouched by European regulation: clearing and settlement (C&S). Both the fragmentation of European post-trade services and the lack of competition in the domain have repeatedly been identified as a barrier to cross-border market integration (e.g. The Giovannini Group 2001, Linda Goldberg et al. 2002). Yet two competitive issues still divide the financial industry and make government agreement on EU-level action impossible: governance structures and consolidation.

The firms providing post-trade services fall under two categories: central counterparties (CCPs) and central securities depositories (CSDs) (see e.g. Cox et al. 2005). When two parties have agreed to a securities trade, for example on a stock exchange, the transaction is commonly arranged via an interlocutor, the CCP, which becomes the actual counterparty to both the seller and the buyer. One to three days normally elapse between the agreement to trade and the actual transaction; to minimize risk in this time-lag as well as to allow the ‘netting’ of buy- and sell-transactions by the same broker, all trades in a particular security are cleared through CCPs. In Europe, the biggest ones are Clearstream, owned by Deutsche Börse, and LCH.Clearnet. CSDs hold the actual securities; they keep book of their ownership and ‘deliver’ them against payment, even if the securities—the tangible pieces of paper—remain immobile in the CSD. Euroclear is the largest CSD in Europe. Finally, market participants who do not want to or cannot deal with CCPs and CSDs directly, for example pension funds, use custodian banks to take care of the payment for and delivery of securities; custodians also collect dividends on shares and perform related services. Custody services are normally provided by large banks. In Europe, the largest custodians are State Street, Bank of New York, JP Morgan and Citigroup. Coming in fifth place, BNP Paribas is by far the largest European firm providing custody services.

From the perspective of efficiency, it is suboptimal to have several CCPs and CSDs in Europe (Goldberg et al. 2002). Banks have to keep balances at all of them. More money has to change hands than would be the case if a single European CCP existed; only then would it be

possible to net for example the sale of Portuguese shares against the purchase of German ones. In short, many observers see the fragmentation of C&S markets as a barrier to true financial market integration. Most large banks would also like to see further consolidation in the field as it would lower their post-trading expenses. The political question is whether consolidation could be forced on the sector for the sake of financial market integration.

The issue of consolidation is wedded to the second stumbling block, governance structures. Formally, most clearing houses (which often also provide settlement services) are independent from the stock exchanges they serve. For example, Euroclear handles the settlement for trades on Euronext, the stock exchange, but also the London Stock Exchange (LSE). It is largely owned by the users of its services—large banks—and neither the LSE nor Euronext can dictate the prices Euroclear charges for its services. Nor can they legally force parties trading on their systems to use Euroclear for settlement. In contrast, Deutsche Börse owns Clearstream, the company which clears and settles the shares traded on its system. Similar ‘silo’ models that integrate trading and post-trading services exist in Italy and Spain. This vertical integration of the value chain has attracted much criticism: banks and other exchanges claim that Deutsche Börse in particular uses its monopoly over the clearing and settlement of German shares to subsidize services in which it competes with other firms. Deutsche Börse’s clearing and settlement system is widely seen as the central obstacle to pan-European consolidation in the industry.

Unsurprisingly, Deutsche Börse denies the veracity and relevance of both claims (Viermetz 2006).

The Commission had been eager to see movement in this area; it saw (and sees) both the lack of consolidation and the vertical integration in some countries as impediments to financial market integration. In its first ‘issues paper’ for the Forum Group on the ISD, clearing and settlement still appeared as a separate agenda point (European Commission 1999a). In later meetings, it had been dropped (e.g. European Commission 2000). Instead, where clearing and settlement was still mentioned, the Commission emphasized it would fall outside considerations for future legislation (Ibid.: 4). As one Commission official remembers:

At one point we had a provision in the MiFID concerning C&S. In the discussion it was there. That you should have free access to C&S systems. But immediately during the debate... Because many member states said 'It is a difficult issue. It's not appropriate to deal with it simply with an article in the MiFID.' That is why what was in the MiFID disappeared. (Interview 141205)

The German government in particular remains obstinate; at the time of researching for this thesis, in 2006, it was clear it would not accept legislative action in this area (Interview 240506.a). Its position largely matches that of Deutsche Börse—never mind the welfare-enhancing prospects that experts commonly associate with consolidation in the industry.

The German government is not alone in opposing legislation. The French government is also hesitant, though this has less to do with the interests of Euronext than the commercial interests of the French banks—the largest custodians in Europe—and of BNP Paribas in particular. The fragmentation of clearing and settlement systems in Europe means that many settlement-related services are handled by custodians. In effect, the latter profit from what is for the rest an inefficient system. As recounted above, the rapport between the largest French banks and the government had been deteriorating (cf. Lalone 2005). But on this particular issue a lobbyist from a French bank with high stakes in the field reported that his bank and the Trésor had reached a 'good understanding' and that the latter had finally arrived 'at the right position'—meaning scepticism towards EU-level legal action (Interview 160506.a). Lobbyists from non-French banks also observed the influence of for example BNP Paribas on the Trésor's position (Interview 231105). Thus firms' loyalty to either the home state or to European integration depends on the issue at hand. As another lobbyist noted, '[o]n the investment business [the French banks] are [European], on C&S they are not' (Interview 021205.a).

Most investment banks of any standing in Europe are united in the European Securities Forum (ESF), a single-issue association that lobbies for more 'efficiency' in the clearing and settlement industry. Only the French banks are absent. BNP Paribas left the ESF in the fall of 2003 because its commercial interests as a major custodian were no longer compatible with the

goal of the abolition of barriers in the sector (Financial Times 2004). Likewise, in the post-FSAP Expert Group on Securities Markets, which gathers industry representatives to advise the Commission, there was only superficial consensus on ‘tackling’ clearing and settlement.

Everyone agrees on that. But tackled—for some people that means a directive, for others it means doing nothing and letting the ‘market’ do its work. (Interview 141205)

For the time being, the latter approach appears to be carrying the day. European bourses have, however, drawn up a voluntary code of conduct (Buck and Cohen 2006). Whether this will lead to changes in the industry is impossible to predict at the time of writing. The example of clearing and settlement shows, however, how a small number of firms—only two, in the eyes of many observers—can stall the Europeanization of an issue area if it goes against their competitive interests and if they happen to have access to powerful member state governments. Competition politics and material interests still trump the supranational push of the institutions that the Lamfalussy process created.

Conclusion: The transnational constellation in EU capital market governance

After twenty years of transformation, the dust appears to be settling. The work programme of the Financial Services Action Plan has basically been completed (European Commission 2007a) while member states are busy implementing its centre piece, the MiFID. For the coming years, the Commission has committed itself to a ‘regulatory pause’ (European Commission 2005c). Instead of making new rules, both Brussels bureaucrats and industry representatives want a shift towards improving the ‘quality’ of existing rules. A new balance has emerged between market structures and the level and scope of capital markets regulation in the EU. The emphasis on ‘improving’ regulation means much of the future work will take place on ‘level 2’ of the Lamfalussy process where implementing measures can be adapted without renegotiating entire directives. Until a wholly new directive will be negotiated to replace the MiFID, both the Council and the European Parliament will largely be excluded from the evolution of EU regulation. Instead, the Commission, CESR and the core private stakeholders—a small group of transnational financial

firms—will collectively decide the direction of further change. This is where the most radical supranationalization of policy-making lies.

The battles between member states that marked capital market negotiations, and to a lesser degree many other FSAP directives, are a thing of the past. The idea behind splitting legislation in two levels is that it can be adapted without renegotiation. The implications for the practice of Brussels policy-making is only now starting to sink in. Legislation can be adapted more rapidly. The split also means that state-market relations will become highly routinized again with the Commission, CESR and industry representatives as its nodes. Both CESR and the Commission have ‘expert’ committees composed largely of industry representatives to advise them. It will be at this level that political conflicts over capital market regulation will be borne out.

Supranationalization has not meant that competition politics have disappeared from the policy process. Far from it. Constituency interests and competing institutional attachments still demarcate the most important political fault lines and at times constitute the stumbling blocks en route to rule harmonization, as was the case in clearing and settlement. Ironically, both the struggle over systemic internalization and clearing and settlement stem from strategic decisions that banks made a decade earlier. Demutualization spilled over from the ‘economic domain’ into politics and left a strong imprint on the current EU infrastructure for securities trading. How things will now develop is impossible to predict, just as banks failed to foresee the political disadvantages that demutualization would bring years later. What does seem safe to say, however, is that a small elite group of financial firms will remain the most important actor group in determining the future evolution of both EU capital markets *and* the rules that govern them.