The Role of Regional Integration in the Development of Securities Markets: A Case Study of the EU Accession Process in Hungary and the Czech Republic

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Introduction: The Inter-relationship Between Accession and Regulatory Development in the Financial Sectors of the CEECs

This paper is primarily concerned with the role that accession to the European Union (EU) has played in the development of a regulatory infrastructure for securities markets in the Central and Eastern European countries (CEECs) that will be officially joining the EU in May 2004. A key aspect to the analysis below of the inter-relationship between EU enlargement and securities regulation in the CEECs will be to distinguish between two separate, albeit inextricably linked, processes that have occurred in the CEECs over the past decade – the preparation for EU integration and the development of a regulatory framework to govern securities transactions.

Many scholars have noted that EU enlargement has largely coincided with the transition in the post-communist CEECs from a state-planned economy to a more market-based economy. As part of this transition, the CEECs have been forced to build from the ground up the institutions and regulatory frameworks that are necessary to support a well-functioning securities market. At the same time as the CEECs were developing the infrastructure for their emerging securities markets, they were also preparing those markets and the underlying regulatory frameworks for integration into the EU’s internal capital market in anticipation of eventual accession. Given the near simultaneous occurrence of EU accession and the CEECs’ transition to a market economy, the

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1 The CEECs that are scheduled to accede to the EU in May 2004 are Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Latvia, Lithuania and Estonia. Cyprus and Malta are also expected to join the EU during this round of enlargement.

2 Consistent with its emphasis on regulatory development in the CEECs, this paper will be more concerned with the impact of EU integration on securities regulation in the CEECs rather than on how this round of enlargement will influence securities regulation at the EU level. As a result, the paper will only address in passing some of the potentially significant effects that accession will have (and perhaps already has had) on EU securities regulation.
fundamental question that this paper seeks to address is whether and to what extent the processes of EU integration and securities market development in the CEECs can productively coexist with one another.3

Hungary and the Czech Republic will serve as the two principal case studies for examining the inter-relationship between accession to the EU and the development of securities regulation in the CEECs. These two countries have been selected for close analysis because they have taken radically different approaches to the regulation of securities markets, notwithstanding the fact that their financial sectors share many similar features. Whereas in the Czech Republic the government initially adopted a laissez-faire approach to securities regulation and only recently established a specialized agency to oversee the domestic securities market, Hungary has been at the forefront of financial sector reform in the CEECs and has experimented with a consolidated approach to financial supervision. With the examples of the Czech Republic and Hungary, one can thus contrast the role of regional integration in a country that resisted a strong regulatory regime for securities markets (the Czech case) with the accession process in a country that was more open to regulatory reform and innovation (the Hungarian case). The experience of financial sector reform during the accession process in these two countries also provides interesting data with which to compare the effectiveness for a developing

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3 Another caveat on the limits inherent in the approach taken by this paper to examine securities regulation in the CEECs – the following sections will concentrate on what has happened in the CEECs during the process of gaining accession to the EU rather than on forward-looking analysis about what may happen with respect to securities markets once the CEECs have joined the EU. Such an approach will therefore ignore one of the most pressing issues that policymakers at both the EU and national levels now face, which is how the entrance of the CEECs into the EU’s internal marketplace will impact the flow of capital between the newly-acceded states in the East and the member states of the West, where securities markets are generally deeper, more liquid and subject to better regulatory oversight.
The organization of the paper is as follows: Part I examines the scholarly literature on law and finance in an effort to create a theoretical model for how EU integration can best serve the goal of developing strong securities markets in the candidate countries. This model suggests that the optimal role for the EU is to use the leverage of accession to foster the development of strong regulatory institutions that can domesticate and enforce EU legislation on securities in the face of entrenched political resistance in the CEECs to financial sector reform. Part II gives an overview of the accession process and reveals that although this process has largely focused on the formal adoption of EU legislation by the candidate countries, the European Commission has also recognized that improvement of regulatory capacity in the CEECs is necessary for a successful round of enlargement. Part III analyzes how oversight from the EU during the accession process played a key role in the establishment of a stronger securities regulator in the Czech Republic despite political resistance to the regulation of financial markets. In the Czech case, one can thus observe how in practice the processes of EU integration and securities market development have converged on the need for a more robust system of financial supervision. Part IV uses Hungary’s experience with consolidated financial supervision as a way to examine a possible tension between what is required for greater financial market integration at the EU level and what many officials in the CEECs believe is the optimal regulatory model for stimulating growth in their emerging securities markets.
Part I: The Implications of Law and Finance Literature for the Accession Process

A. Overlap Between EU Enlargement and Capital Market Development in the CEECS

A defining feature of the CEECs’ accession to the EU is the extent to which that process has overlapped with the transition in those countries from a command economy to a market-based economy. It has been less than 15 years since the CEECs began to withdraw from the Soviet Union’s sphere of influence and progressively replace the state-planned economic model that had been imposed by the former communist regimes with a Western-style market economy. From the very beginning of this transition, the CEECs indicated their interest in joining the EU and structured many of their initial reforms with a view towards eventual accession. After early bilateral discussions with the CEECs on the subject of regional integration, the European Commission (the “Commission”) published its White Paper in 1995 that provided the CEECs with a detailed road map for gaining accession to the EU. During the period from 1997 to 1999, the EU began negotiating formal accession treaties with 8 candidate countries in Central and Eastern Europe (Poland, Hungary, the Czech Republic, Estonia, Latvia, Lithuania, Slovakia and Slovenia) and all are scheduled to become full member states in May 2004. As illustrated

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4 See Jim Rollo, Economic Aspects of EU Enlargement to the East, in ENLARGING THE EUROPEAN UNION: RELATIONS BETWEEN THE EU AND CENTRAL AND EASTERN EUROPE 254 (Marc Maresceau ed., 1997) (“[t]he major issue which separates this enlargement from previous enlargements is the question of transition from communism to democracy and the market”).

5 This linkage between EU integration and transitional reform was noticed early in the accession process by two scholars who wrote in 1996 that the EU now “serves as a beckoning ‘bridge’ for luring, in a positive way, the Eastern European countries into viable economic and legal reform. Over the past few years, it has become apparent that virtually all of the Eastern European countries look toward some form of eventual direct or indirect link to the European Union and its members states for the purposes of economic, political, and defence security and stability. Accordingly, the Eastern European countries will most often seek out ‘EU compatible’ models for their respective reform efforts.” Joseph Norton & Hani Sarie-Eldin, Securities Law Models in Emerging Economies, in EMERGING FINANCIAL MARKETS AND THE ROLE OF INTERNATIONAL FINANCIAL ORGANIZATIONS 341 (Norton & Mads Adenas eds., 1996).
by this brief timetable of accession, which will be developed more fully in Part II of the paper, the transitional reforms in the CEECs have taken place largely in the shadow of EU integration and it is therefore difficult to separate these two processes from one another.

Perhaps nowhere is this link between transition to a market economy and EU integration more apparent than in the evolution of securities markets in the post-communist CEECs. Capital markets, as they are known in the West, simply did not exist in the state-planned economies of the CEECs and began to appear throughout the region in embryonic form only after the collapse of the Soviet Union’s sphere of influence from 1989 to 1991. As a result, there was practically no local knowledge of, or experience with, financial sector regulation and supervision in the CEECs at the start of the transition to a market economy. Scholars have noted that creating securities markets as well as the corresponding regulatory infrastructure from the ground up, as the CEECs have been forced to do, is a complex process that takes many years, if not decades, to complete.

The intention of the CEECs to join the EU has only increased the pressure to rapidly develop the infrastructure for securities markets. As a prerequisite for EU membership, the CEECs must adjust their legislative and regulatory frameworks to the standards applicable in the EU and the degree of that adjustment determines when

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6 Karel Lannoo, Financial Sector Regulation in CEECs and EU Accession, in EUROPEAN UNION ACCESSION: OPPORTUNITIES AND RISKS IN CENTRAL EUROPEAN FINANCES 295 (World Bank, 2000).

7 Id.

accession will take place. Since the CEECs were only at the beginning stages of developing securities markets and financial sector regulation when the accession process began in the early 1990s, the EU legislative framework has served, in effect, as a transition benchmark for the CEECs’ attempts to create well-regulated securities markets. Given how closely integration to the EU has followed the transition in the CEECs to a market economy, the accession process has therefore presented the EU and the candidate countries with the dual challenge of (1) developing efficient, well-regulated securities markets within a short period of time and (2) preparing those markets for integration into both the EU internal market and its regulatory structures.

This dual task of both developing and integrating the CEECs’ emerging financial sectors puts the EU in the somewhat unfamiliar position of having to build from the ground up – or at least oversee the building of – the institutions that are necessary to support strong securities markets in the CEECs. It should be noted that the EU does have considerable experience in integrating countries with varying levels of economic development into its internal marketplace. A number of factors, however, indicate that the accession of the CEECs presents the EU with a fundamentally different situation than previous enlargement rounds. First, the CEECs display a level of economic development that is considerably below levels both in previously acceding states and in the poorest current EU member states. In particular, securities markets in the CEECs are at a much

\[9\] Id.

\[10\] The “latecomers” to the EU (Greece in 1981; Spain and Portugal in 1986; and Austria, Finland and Sweden in 1995) provide an excellent example of the EU’s proven ability to integrate countries with varying levels of economic and financial sector development into its single internal market.

\[11\] Hungarian Financial Supervisory Authority, Effect of EU Accession on Financial System 5 (2001), at http://www.pszaf.hu/english/start.html. See also Rollo, supra note 4 at 254; and Lannoo, supra note 6 at 254.
lower stage of development than the more established markets in the EU. As a general rule, the smallest equity markets in the current EU member states are several times larger than the biggest markets in the CEECs.\footnote{Wieslaw Rozlucki, Emerging Stock Markets in Central Europe: Where Do We Stand?, in FINANCIAL TRANSITION IN EUROPE AND CENTRAL ASIA: CHALLENGES OF THE NEW DECADE 141 (Lajos Bokros et al eds., 2001).} The disparity between the size of equity markets in Western and Eastern Europe can be seen in Appendix A, which presents the most recent figures on equity market capitalization for the major stock exchanges in Europe. The available data thus suggests that the gap in economic development – especially in securities markets – between the acceding countries and current member states that must be reduced for a successful integration to the EU single market is greater with respect to the CEECs than it was during previous enlargement rounds.

Another unique feature of this current enlargement round is that it is being completed in a much shorter period of time than prior rounds. In the past, countries wishing to join the EU were given “Association Agreements” with lengthy time frames for the achievement of free trade in industrial goods.\footnote{CHRISTOPHER PRESTON, ENLARGEMENT AND INTEGRATION IN THE EUROPEAN UNION 204 (1971).} For instance, Greece and Spain each spent over sixteen years at the Association Agreement stage before becoming full member states of the EU. Even wealthier countries like Austria, Sweden and Finland, due to their 1972 Free Trade Agreement with the EU and their participation in the internal market through the European Economic Area, had twenty years of tariff-free trade in industrial goods before moving to the next level of EU integration.\footnote{Id.} As a group, the CEECs will have completed the entire process of integration, from Association

\footnote{Id.}
Agreement to full member state status, in less than 13 years. Put most simply, the CEECs had more catching up to do in terms of economic development and a shorter period of time within which to do it than was the case in earlier rounds of enlargement.

A final important difference between the EU’s prior experiences with enlargement and the accession process for the CEECs concerns the level of regulatory development in the candidate countries. Whereas in previous enlargements involving lesser developed economies like Greece, Spain and Portugal the candidate countries only needed to adapt their already existing regulatory systems to the EU framework, the CEECs must create entirely new structures for the regulation of a market-based economy during the accession process. Regulatory development, and not regulatory adjustment, is therefore a key component of this enlargement round.

Given the underdeveloped state of the CEECs’ financial sectors, the current round of enlargement has forced the EU to assume a more active role in the development of institutions that underlie a mature securities market than it had in previous cases of accession. As an indication of how large a “developmental” role the accession process has played in the CEECs, one scholar has even suggested that by 1996 the EU had surpassed the World Bank, the IMF, the European Bank for Reconstruction and Development, and the Organization for Economic Cooperation and Development as the most important multilateral institution for economic development in Eastern Europe.

15 Rollo, supra note 4 at 256. Rollo suggests that it is actually easier for the CEECs to build regulatory institutions from the ground up that are modeled after the EU’s system rather than to make significant changes to existing regulatory structures as Greece, Portugal and Spain did.

It is interesting to note that the Commission has expressed optimism about this new role for the accession process as a driving force behind financial sector development and reform in the CEECs. Indeed, the former Head of the Commission’s Banking and Financial Institutions Division, Paolo Clarotti, wrote an article asserting that the EU legislative framework can serve as a model for financial sector reform not only in the CEECs but in any emerging financial market. This statement from a member of the Commission’s staff presents squarely the fundamental question that the paper seeks to address below – to what extent can the process of adopting the EU’s framework for financial sector regulation play a constructive role in developing the necessary infrastructure to support securities market growth in the CEECs.

B. Lessons From Academic Studies on the Relationship between Law and Securities Market Development

There has been a recent growth in research on the relationship between law and financial market development that is useful in evaluating the contribution that the accession process can make to the creation of an infrastructure for securities markets in the CEECs. Much of this current scholarly interest in the field of law and financial sector development can be attributed to studies undertaken by a group of economists – La Porta, Lopez-de-Silanes, Shleifer and Vishny (collectively, “LLSV”) – that demonstrate a significant relationship between legal protections for minority shareholders and creditors and patterns of corporate finance in different countries, including the relative size and

efficiency of securities markets.\textsuperscript{18} Although the LLSV and related studies seem to confirm the long-held intuition that securities markets will not develop in the absence of a legal framework guaranteeing that investors have basic contractual and property rights, a number of scholars have questioned the causal relationship that these studies posit between law and financial development. Rather than law stimulating development in financial markets as LLSV suggest, these critics point to historical evidence suggesting that legal developments have tended to follow, not precede, economic change.\textsuperscript{19} One instructive hypothetical for this “reversal” in causality is that a greater level of financial development (and the corresponding increase in investor population) may actually cause the enactment of laws providing for stronger investor protections.\textsuperscript{20}

Even if one assumes that as a general proposition law does “matter” (i.e., that legal protection for investors is somehow causally linked to capital market development), policymakers still face the more practical question of how to generate the legal protections and institutions that are necessary to support a strong securities market.\textsuperscript{21} A number of recent studies that have focused on this process of generating legal norms and institutions in emerging financial markets suggest that there are three major areas where the accession process may encounter problems in developing a regulatory infrastructure for securities markets in the CEECs.


The first area where the accession process may face difficulties in developing a regulatory infrastructure for securities markets can be found in the CEECs’ importation of EU securities legislation. As will be detailed in Part II, the backbone for the accession process is the incorporation of all EU legislation into the national law of the candidate countries. In the field of securities regulation, then, the CEECs must fully implement the EU directives on securities into their domestic legal regimes during the accession process. It should be noted that this strategy of domesticating a set of foreign rules for securities markets is quite commonplace.\(^{22}\) Previous examples of the domestication of foreign securities law include Japan, where following the Second World War policymakers adopted securities laws modeled after those in the U.S., as well as Malaysia and Singapore, where securities regulation was formulated on the basis of Australian law.\(^{23}\)

Despite the fact that several developing nations have followed to varying degrees of success this strategy of domesticating the securities laws of another country, there are nonetheless a number of problems associated with the direct adoption of a foreign legal regime. First, as Guzman notes, “every country possesses unique characteristics that may make a foreign set of laws unsuitable for domestic use. Even among developed countries, differences in national laws reflect in part local culture and practice. Differences between developed and developing countries are typically even more pronounced.”\(^{24}\)

\[^{21}\] Choi, supra note 18 at 1694.


\[^{23}\] Id.

\[^{24}\] Id. at 619. See also Michel Tison, *Harmonisation and legal transplantation of EU Banking Supervisory Rules to Transitional Economies. A Legal Approach*, University of Ghent, Financial Law Institute, Working Paper No. WP 1999-12 (July 1999), at http://ssrn.com/abstract=173769 (arguing that the
potential drawback to the domestication approach is that a lack of familiarity with the
basic legal principles of the foreign securities law may create confusion and uncertainty
among participants in the financial markets. In a recent study on this process of
importing rules from abroad, Berkowitz, Pistor and Richard found that countries that
have received foreign legal regimes without adapting them to local conditions or
familiarizing the population with the imported law have greater difficulties in developing
effective legal systems, producing what they refer to as the “transplant effect.” The
above literature on legal transplants suggests, then, that a country seeking to domesticate
foreign securities laws would be well advised to establish institutions that are charged
with adapting the transplanted law to local conditions and educating market participants
on the basic principles behind the transplanted law.

Unless the accession process is sensitive to the need for localized adaptation of
EU legislation in candidate countries, the transplant effect is likely to prevent the CEECs
from successfully implementing the EU directives on securities into an effective legal
regime. The most important reason why the incorporation of EU directives on securities
by itself will not create an adequate legal framework for securities markets in the CEECs
is that these directives are geared towards the specific aim of promoting capital market
integration, not the creation of a comprehensive legal regime for securities. The EU
framework for securities regulation is based on the dual principles of minimum standards
and mutual recognition, whereby each member state incorporates into its national

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26 Id. at 168.
legislation standards that must be no less stringent than the minimum requirements contained in the EU directives.\textsuperscript{27} The principle of mutual recognition, however, ensures that member states choosing to adopt more stringent standards do not create unnecessary barriers to capital market integration within the EU by allowing an issuer from one member state to access the securities markets in another member state on the basis of its home country requirements.\textsuperscript{28}

As this brief overview indicates, EU legislation on securities is based on legal principles that serve to dismantle barriers between securities markets and does not purport to establish a full-blown regulatory regime for securities at the national level. Indeed, the EU directives on securities provide substantive standards only to the extent necessary to create an EU-wide floor of protection. One commentator has described the overall picture of securities regulation at the EU level as consisting of a partial body of common concepts and regulatory patterns designed to promote capital market integration, while a large part of the field remains uncovered.\textsuperscript{29} In his study of the implementation of EU banking directives, which are also based on the dual principles of mutual recognition and minimum standards, Michel Tison notes that the almost mechanical incorporation of

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\textsuperscript{27} Two of the more important EU directives on securities are: (1) the Listings Particular Directive, which allows an issuer from a member state with securities listed on its home country exchange to list its securities on other exchanges within the EU without having to comply with the full listing requirements of the other exchanges; and (2) the Public Offers Directives, which allows an issuer from a member state to use selling documents prepared under its home country rules for public offerings in other member states. See Howell Jackson & Eric Pan, \textit{Regulatory Competition in International Securities Markets: Evidence from Europe in 1999 – Part I}, 56 BUS. LAW. 653, 662 (2001). For an extensive overview of the EU securities framework, see NIAMH MOLONEY, EC SECURITIES REGULATION (2002).

\textsuperscript{28} Jackson & Pan, \textit{Id.} at 662.

these directives to date by the CEECs has produced regulatory regimes in those countries that lack some of the necessary elements for strong financial supervision.\footnote{See Tison, supra note 24 at 25.}

In addition, some scholars have argued that even the minimum standards in the EU directives, which were originally designed for more developed economies in Western Europe, are inappropriate for the CEECs and may have adverse effects on the regulation of their capital markets. For instance, Karel Lannoo points to the minimum level of protection imposed by the EU Deposit Guarantee as one example where the standards in EU directives are too high in relation to the size of the CEEC economies.\footnote{See Lannoo, supra note 8 at 105.} As Lannoo notes, a deposit protection scheme based on average income in the EU may stimulate excessive risk-taking and moral hazard in the capital markets of the CEECs, where GDP per capita varies between one-quarter and three-fifths of the average level in the current EU member states. Given that financial services legislation at the EU level is geared towards the integration of capital markets at higher stages of development and does not purport to replace all home country regulation, one would therefore expect that the mere incorporation of the EU directives on securities by the CEECs, without further adaptation, would result in a legal regime that is not suitable for the comprehensive regulation of domestic securities transactions in an emerging financial market.

A second area where the accession process may have difficulty generating an effective legal regime for securities in the CEECs is in the enforcement of the “transplanted” legislation. There is a growing body of data suggesting that enforcement must at least be credible in order for the law on the books to effect financial market
In a recent survey of insider trading laws in 103 different countries, Utpal Bhattacharya and Haem Daouk report that while the cost of equity in a jurisdiction does not change after the introduction of insider trading laws, it decreases to a statistically significant extent after the prosecution of the first insider trading case. Another group of researchers have found in their analysis of shareholder and creditors protections in transition economies that the level of enforcement has a much higher explanatory power for growth in equity and credit markets than the quality of the law on the books.

Although the research cited above provides strong evidence that enforcement of securities legislation must be a priority for the development of a well-functioning securities market, there remains the question of which institution is in the better position to enforce that legislation in a transition economy – the judiciary or public regulators? The economists Andrei Shleifer, Edward Glaeser and Simon Johnson have taken up this question in their study of securities regulation in Poland and the Czech Republic during the early 1990s. Based on the application of a theoretical model for regulatory behavior to securities legislation in these two countries, they hypothesize that in emerging financial markets – where costs are high for obtaining evidence in specific cases and interpreting exceedingly technical statutes – regulators may have better incentives to


33 See Utpal Bhattacharya & Haem Daouk, The World Price of Insider Trading, 57 J. FIN. 75 (2002). Note, however, that the authors are somewhat hesitant in attributing causality to an enforced insider trading ban because the first prosecution of insider trading is also related to an increase in that country’s credit rating.

protect those legal rights that promote securities market development than does the
judiciary. Another study on the institutional mechanisms for the enforcement of
securities laws has emphasized that whereas courts can only react to enforcement
proceedings brought by a third party, a regulator may initiate law enforcement
proceedings and is thus in a better position to stop actions even before harm has been
done. Insofar as this literature suggests that regulators have greater incentives to bring
enforcement proceedings as well the capacity to proactively enforce securities laws, it
appears that the best approach for developing strong securities markets in the CEECs
would be to create regulatory institutions with broad enforcement mandates rather than to
rely on private parties and the judicial system to police violations of securities laws.

In addition to providing the benefits of better enforcement, strong regulatory
institutions in the CEECs would also be well-placed to develop the technical expertise
that is necessary to domesticate EU legislation and educate the marketplace, thereby
mitigating any of the possible transplant effects that were described above. According to
research within the law and finance field, it is regulators, and not necessarily substantive
legislation, that should be the focal point for the development of strong securities markets.

A final potential obstacle for the development of institutions to support securities
markets in the CEECs relates to the political and economic forces in those countries that
may resist attempts at financial sector reform. In an article on the necessary
preconditions for a strong securities market, Bernard Black describes a self-reinforcing

at 30 (suggesting that a practical approach to effective enforcement of securities laws in transitional
economies may lie in creating a cadre of administrative judges within an SEC-like agency).
cycle – what he refers to as a “separating equilibrium” – that prevents countries from easily transitioning from an economy dominated by bank financing and closely-held conglomerates to one based on securities markets. Black writes that:

If securities markets are weak, companies and countries will develop other ways to finance businesses. Bank financing is an obvious alternative. But bank-dominated financing produces strong banks, both financially and politically. The banks will resist legal changes that might strengthen securities markets. Family-run conglomerates are a second alternative. Once built, they reduce the need for a strong securities market. Insiders of family conglomerates and other already public companies will then fight against rules and institutions that limit self-dealing.

In this environment, where banks and closely-held conglomerates control most of the capital, Black’s equilibrium model predicts that strong political opposition will develop in response to any attempts at building the institutions, especially regulatory agencies with substantial enforcement powers, which underlie a strong securities markets. What results, then, is a self-perpetuating cycle in which the absence of institutions to support a securities markets produces capital markets that are dominated by banks and closely-held conglomerates, which in turn use their political influence to block the development of institutions that could strengthen securities markets. Since the CEECs now have in place a financial sector dominated by banks, Black’s equilibrium model predicts that any attempt by CEEC officials to shift the financial sector towards securities markets will meet with strong political opposition.

In discussing Black’s equilibrium model, Stephen Choi suggests that regulatory competition may be the best mechanism to overcome entrenched political opposition to the development of an infrastructure for securities markets. Choi argues that once

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securities markets participants have the ability to opt into different legal regimes, national regulators will face competitive pressures to develop their own country-specific reforms aimed at increasing investor protections.\textsuperscript{38} With respect to the CEECs, regulatory competition may prove to be an effective mechanism for stimulating legal and institutional reform of securities markets when these countries become full-fledged members of the EU and subject to the competitive pressures from its internal capital market. The point of the accession process, however, has been to establish, prior to full admission to the EU, a legal infrastructure for securities that will enable the CEECs to responsibly participate in the EU’s internal market for capital. In fact, the EU currently has at its disposal a much more direct mechanism for stimulating institutional reform in the CEECs than regulatory competition – the ability to defer or even withhold membership privileges to the candidate countries. Since the EU can defer or deny membership to candidate countries for the inadequate regulation of securities markets, it is likely that policymakers in the CEECs who are attempting to build a regulatory infrastructure for securities can use political pressure from the EU during the accession process to overcome the domestic resistance to such reforms that Black’s model predicts for countries like the CEECs which are dominated by bank financing and closely-held conglomerates.

The law and finance literature described above suggests three specific obstacles that the CEECs will face during the accession process to the development of institutions that are necessary to support a strong securities market. First, the EU law on securities is not geared to the creation of a complete domestic legal regime and therefore must be

\begin{footnotesize}
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\item[37] Black, \textit{supra} note 32 at 840.
\item[38] Choi, \textit{supra} note 18 at 1695.
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\end{footnotesize}
carefully adapted by policymakers in the CEECs to fill country-specific needs. Second, the law on the books needs to be credibly enforced in order to make a significant contribution to the development of a well-functioning securities market. As a result, the CEECs will need to develop institutional mechanisms for enforcing the securities laws that they have recently “transplanted.” Research indicates that regulators may be better enforcers of securities laws than the judiciary in transition economies. Finally, politically-powerful interest groups such as banks and closely-held conglomerates may resist any attempts by policymakers in the CEECs to develop an institutional structure to support securities markets.

Although the EU can play an important role in helping the CEECs respond to these challenges, the mere incorporation of EU legislation is not sufficient to develop an effective legal regime for securities in the CEECs. Rather than substantive regulation, political leverage appears to be the most significant contribution that the EU can make during the accession process to the emerging securities markets of the CEECs. More specifically, the law and finance literature suggests that the optimal role for the EU is to use the leverage of the accession process, when membership privileges can be deferred or denied, to foster the development of strong regulatory institutions in the CEECs that can domesticate and enforce the “transplanted law” in the face of entrenched political resistance to financial sector reform.
Part II: Overview of the EU’s Pre-accession Strategy for the CEECs

This section will assess the EU’s framework for accession in light of the model outlined in Part I, which indicates that the optimal role for the EU in developing securities markets during the accession process is to pressure the CEECs into creating strong regulatory institutions to oversee those markets. In the analysis below, it is suggested that, in contrast to prior enlargement rounds, the EU has somewhat modified its pre-accession strategy to account for the relatively low level of regulatory development in the CEECs, thereby increasing the likelihood that regional integration will spur the institutional reform necessary for the creation of stronger securities markets in the CEECs.

A. The Classical Method of EU Enlargement

The four previous rounds of EU enlargement have established a consistent pattern for the procedures that the EU has adopted in order to admit candidate countries as full member states. One scholar has referred to this pattern as the “classical method” of EU enlargement and has identified the principles that underlie this method. The most important principle is that candidate countries must accept in full the acquis communautaire, a concept that has been defined as “the actual and potential rights and obligations attaching to the Community system, and its institutional framework.” For the purposes of accession, the main component of the acquis is the legislation adopted pursuant to EU treaties and the case law of the European Court of Justice interpreting that legislation.

39 See PRESTON, supra note 13 at 9. The four previous rounds of EU enlargement are as follows: 1) Denmark, Ireland and the United Kingdom in 1973; 2) Greece in 1981; 3) Portugal and Spain in 1986; and 4) Austria, Finland and Sweden in 1995.

40 Id. at 18.
The second principle of the classical method of enlargement is that the accession process is to focus almost exclusively on the practicalities of the adoption by the candidate countries of the *acquis*. According to this second principle, the EU’s pre-accession strategy is typically limited to negotiating time-limited transitional periods, setting target dates for the removal of tariffs and quotas, and providing for the incorporation of EU legislation into the national law of the candidate countries.\footnote{Preston argues that the classical method’s narrow focus on the technicalities of adopting the *acquis* serves the important function of insulating the accession negotiations from wider debates among member states about the relative merits of integration that may prove fatal to the enlargement process. \textit{Id.} at 9.} The end result of the classical method is a rather formal procedure for enlargement that takes the implementation of EU legislation as its chief benchmark for accession.

The accession of the CEECs to the EU has put pressure on this classical method for enlargement. As noted in Part I, the aggregate level of economic development and administrative capacity in the CEECs is much lower than in any of the states involved in the previous rounds of enlargement. In addition, the CEECs have a shorter transitional period than former candidate countries to adopt a more extensive *acquis*. Despite the qualitative differences between this current round of enlargement and prior rounds, the EU’s pre-accession strategy has largely followed the classical method, especially with respect to using the implementation of the *acquis* as the main benchmark for accession. In documents relating to the CEECs’ accession, however, there does appear to be an increasing recognition by the EU on the need to depart from the classical method’s limited focus on the implementation of the *acquis* and take a more active stance towards developing, in particular, the administrative capacity of the CEECs to oversee and enforce the laws on their books.
B. The CEECs and EU Enlargement

One can roughly date the start of the accession process for the CEECs during the period from 1986-1991, when the Soviet hegemony over Eastern Europe began to decline and the CEECs opened negotiations on trade and cooperation with the European Community. As the rate of political and economic reforms increased in the CEECs, it became clear as early as 1990 that the transition process in Eastern Europe required a broader response from the EU.\footnote{Id. at 198.} To that end, the EU began negotiating the so-called “Europe Agreements” with the individual CEECs, starting with Poland and Hungary in 1991. By 1995, all of the CEECs had concluded European Agreements with the EU. The core of these European Agreements is a commitment to create a free trade area (limited by the exclusion of certain sensitive products and industries) between the EU and the individual CEECs over a 10-year transitional period. Another important aspect of the European Agreements is that they also call for the CEECs to harmonize their national laws with EU norms.

Although the European Agreements represented a tentative first step towards regional integration, the CEECs began to pressure the EU to develop a more structured approach for possible future rounds of enlargement. In response, the EU took up the issue of accession at the Copenhagen European Council meeting in June 1993.\footnote{This paragraph relies heavily on the description of the Copenhagen Council given by Carson Clements in his Note, A More Perfect Union? Eastern Enlargement and the Institutional Challenges of the Czech Republic’s Accession to the European Union, 29 SYRACUSE J. INT’L L. & COM. 401, 415 (2002).} At this meeting, the Council recognized the right of the CEECs to join the EU when they have fulfilled three essential criteria. First, the candidate country must have a stable political
environment with established institutions that guarantee democracy, the rule of law, human rights, and respect for minorities. Second, the candidate country must have a functioning liberalized economy. Finally, each candidate country must fully incorporate the *acquis* into its national law as well as create “the conditions for its integration through the adjustment of its administrative structures, so that community legislation is implemented effectively through administrative and judicial structures.”

While the Copenhagen Council largely restated in these criteria many of the principles of the classical method of enlargement relating to the acceptance of the *acquis*, the language from the Council’s conclusion indicates an intent to look beyond the formal adoption of the *acquis* to review each candidate country’s institutional capacity to make EU legislation effective.

The next significant development in the accession process was the publication in 1995 of the Commission’s White Paper on preparing the CEECs for integration into the EU’s internal market (the “White Paper”). In this document, the Commission outlined a three-pronged pre-accession strategy for a phased adoption by the CEECs of the internal market *acquis*. The first element to the Commission’s strategy was to identify the key EU legislation for each sector of the internal market that the CEECs must incorporate into their national law and to suggest a sequence by which that legislation should be implemented. In addition to legislative harmonization, the Commission also placed particular emphasis in the White Paper on the capacity of the CEECs to administer and enforce the EU rules on the internal market. The Commission explained its stress on administrative capacity thusly:

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The main challenge for the associated countries in taking over internal market legislation lies not in the approximation of their legal texts, but in adapting their administrative machinery and their societies to the conditions necessary to make the legislation work. This is a complex process requiring the creation or adaptation of the necessary institutions and structures, involving fundamental changes in the responsibilities of both the national administrative and judicial systems and the emerging private sector.\footnote{45}

The second element to the White Paper’s pre-accession strategy was therefore to assist the CEECs in identifying the regulatory structures necessary to make the EU legislation on the internal market effective.\footnote{46} Finally, the White Paper provided for a technical assistance program ("PHARE") that would supply funding and expertise from member states to help the CEECs both incorporate EU legislation into national law and create the regulatory structures to administer that legislation. In sum, the White Paper represents the clearest statement by the EU on the necessity of expanding its pre-accession strategy with respect to the CEECs to include a comprehensive review of the effectiveness of national regulatory institutions.

The CEECs saw the White Paper as a “green light” for accession and quickly moved to present their applications for membership during the period from 1994 to 1996.\footnote{47} After a number of preliminary discussions at the EU level on the subject of accession, the Commission issued in July 1997 its “Agenda 2000” publication, in which

\footnote{45}European Commission, Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union, COM(95)163, at http://europa.eu.int/en/record/white/east955/index.htm.

\footnote{46}For a description of the legislation and institutions that the White Paper identified as key priorities with respect to the financial sector, see EUROPEAN UNION WHITE PAPER: ENTRY OF THE CENTRAL AND EASTERN EUROPEAN COUNTRIES INTO THE EUROPEAN UNION 281-92 (1997).

\footnote{47}See Clements, supra note 43 at 417. While Hungary and Poland filed their applications in 1994, Bulgaria, Estonia, Latvia, Lithuania, the Slovak Republic and Romania filed in 1995. The Czech Republic and Slovenia followed with their applications in 1996.
it assessed the prospects for future enlargement and rendered an opinion on the progress of the 10 CEEC applicants in fulfilling the Copenhagen criteria. The documents contained in “Agenda 2000” continue the White Paper’s theme of ensuring that the CEECs develop the institutional capacity to adequately oversee and enforce EU legislation. Accordingly, the Commission found that the main weakness with respect to the CEECs’ implementation of the *acquis* was their administrative and judicial capacity to apply and enforce it satisfactorily.\(^{48}\) Based on its findings on the overall progress of reform in the CEECs, the Commission recommended opening accession negotiations with the Czech Republic, Hungary, Estonia, Poland and Slovenia.\(^{49}\)

Shortly thereafter at the Luxembourg European Council in December 1997, the Council solidified its enlargement policy by agreeing to launch an accession process compromising the 10 CEECs, Cyprus and Malta. While the Council called for bilateral intergovernmental conferences in March 1998 to begin official accession negotiations with Cyprus, Hungary, Poland, Estonia, the Czech Republic and Slovenia, it also provided for future accession negotiations with Romania, Slovakia, Latvia, Lithuania and Bulgaria based on each country’s continued progress on the adoption of the *acquis*.\(^{50}\) As an integral part of the EU’s pre-accession strategy, the Council required the Commission to submit annual reports on the progress of each applicant state towards fulfilling the Copenhagen criteria for accession. These reports were to provide a framework for the conduct of the current accession negotiations as well as determine when negotiations

\(^{48}\) Clements, *supra* note 43 at 420.

\(^{49}\) Id.

were to be officially opened with the other applicant states. In addition to the annual reporting requirement, the Council also decided to increase the amount of pre-accession aid sent to the applicant states through the PHARE program, which was directed to focus on the two priority aims of the adoption of the *acquis* and the reinforcement of judicial and administrative capacity. Expenditures related to the adoption of the *acquis* were to receive approximately 70% of the total PHARE budget, while the remaining 30% was to be allocated to the reinforcement of the judicial and administrative capacity.

Since the Luxembourg European Council’s decision in 1997, the accession process has proceeded apace. Based on the findings from its annual reports, the Commission recommended in October 1999 that official accession negotiations be opened with Bulgaria, Latvia, Lithuania, Romania, the Slovak Republic and Malta. By December 2002, negotiations were concluded with all applicant states with the exception of Bulgaria and Romania. In April 2003, the EU signed a Treaty of Accession with the 10 applicant states that had concluded their negotiations. Popular referenda in support of accession have been passed in the 10 applicant states and all are scheduled to join the EU on May 1, 2004. Bulgaria and Romania have continued with their accession negotiations and expect to join the EU by 2007.

This overview of the accession process suggests that the EU has not radically altered the pre-accession strategy that it had developed during previous rounds of enlargement. The incorporation of the internal market *acquis* remains the backbone of the accession process, as the candidate countries must fully incorporate EU legislation

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51 *Id.* at Point 29.

52 *Id.* at Point 18.
into their national law in order to join the EU as a member state. As a result, accession negotiations with the CEECs have all largely focused on issues associated with how EU legislation is to be implemented into each country’s national law.

Notwithstanding its continued reliance on the classical method, the EU has recognized that as transition economies the CEECs present a different set of challenges for the pre-accession period than the states involved in prior rounds of enlargement. In particular, the EU has shifted its pre-accession strategy away from an exclusive reliance on the adoption of the *acquis* and devoted more attention and resources towards the development of adequate regulatory structures in the CEECs. The White Paper identifies the establishment of supervisory bodies to ensure that financial institutions are respecting the laws and regulations under which they work as a key measure for the CEECs during the accession process.\(^\text{53}\) The annual reports submitted by the Commission contain sections that describe the progress made in the candidate country on improving judicial and administrative capacity for each sector of the internal market (including the financial sector). In addition, nearly a third of each annual PHARE budget has been allocated for the strengthening of judicial and regulatory bodies in the CEECs. Although the accession process for the CEECs does not represent a clear departure from the classical method of enlargement, the EU has been willing to look past the EU law as it appears on the books of the candidate countries and take a more active role in developing institutions to enforce and administer that law.

The EU’s concern for regulatory development in the CEECs dovetails nicely with the conclusions drawn in Part I from the review of the law and finance literature, which

\(^{53}\) See EUROPEAN UNION WHITE PAPER, *supra* note 46 at 281.
suggests that a strong regulatory institution may be optimal for the development of securities markets in a transition economy. It should be noted, however, that the primary motivation behind the EU’s emphasis on regulatory development was not necessarily to stimulate securities market growth in the CEECs. Instead, the more likely scenario is that the EU wanted to protect the integrity of its internal market system from the abuses that might occur as a result of a permissive regulatory environment in the CEECs. What the accession process represents, then, is not so much a case where a regional organization set itself the goal of both integrating and developing the securities markets of prospective members, but rather a happy convergence between the requirements for an effective integration process and the necessary preconditions for a strong securities market. It is this convergence towards a need for strong regulatory institutions, and not necessarily any intrinsic link between the goals of integration and securities market development, that has provided the EU with an opportunity to make a significant contribution to the strengthening of securities markets in the CEECs during the accession process.
Part III: EU Accession and Securities Regulation in the Czech Republic

Although the Commission recommended in 1997 that the EU begin official accession negotiations with the Czech Republic, it noted in its “Agenda 2000” report that the Czech securities markets were plagued by a number of serious problems. As the Commission pointed out in the report, the Czech securities markets were notorious among investors for being poorly regulated, non-transparent and subject to widespread manipulation. Yet by April 2003, both the Commission and the European Council felt comfortable enough with the Czech Republic’s oversight of its securities markets to conclude negotiations and enter into an accession treaty with the Czech Republic. The goal of this section is to first detail the problems afflicting the Czech securities markets in 1997 and then discuss the role that the EU played as Czech authorities tried to remedy these problems during the run-up to accession.

A. Privatization and the Early Development of an Infrastructure for Securities Markets

It is interesting to note that the Prague Stock Exchange, which is currently the only official exchange for securities trading in the Czech Republic, was first established in 1871. During the 19th and early 20th century, the Prague Stock Exchange became an important engine for commerce in the region by providing merchants with a relatively liquid market for bills of exchange and foreign currency. While equity securities were admitted for listing on the exchange, they were traded with much less frequency than the bills of exchange or foreign currency. With the advent of World War II, however, all

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trading operations ceased and the exchange remained closed for the duration of communist rule in Czechoslovakia. The exchange finally re-opened for trading in April 1993. Although the Prague Stock Exchange can thus trace its roots back to the 19th century, the long hiatus between the beginning of World War II and the end of communism in Eastern Europe has rendered that history of little practical value to reformers seeking to establish securities markets in the Czech Republic during the early 1990s.

It was privatization that became the driving force behind the re-opening of the Prague Stock Exchange in 1993 and other attempts by the government to create a trading infrastructure and regulatory framework for securities in the Czech Republic. As has been detailed by many commentators, Czech authorities were determined after the so-called “Velvet Revolution” in 1990 that effectively ended communist rule in Czechoslovakia to move state-owned assets into the private sector as quickly as possible and initiated the first wave of a mass privatization program in 1992 that privatized some 1,600 companies.\footnote{Many scholars have compared the Czech approach to privatization, which was designed to transfer assets from the state as quickly as possible and gave little attention to problems of regulation, to the Polish approach, which proceeded much more gradually and provided for greater state supervision over the process. See Coffee, supra note 32 at 10; and Shleifer et al., supra note 35 at 867.} The second wave of the program was completed in 1994 and resulted in the privatization of approximately another 800 companies. As a result of this mass privatization program, the private sector share of Czech Gross Domestic Product increased from 12% in 1990 to 74% by 1996.\footnote{Coffee, supra note 32 at 11.}

The trading infrastructure for the modern Czech securities markets arose out of the government’s attempts to rapidly privatize the national economy. A key component
of the Czech government’s strategy for large-scale privatization were voucher auctions, in which a citizen could purchase vouchers for a symbolic fee and then trade those vouchers in auctions for shares of the roughly 2,400 companies that were privatized. An electronic trading system, called the RM-System, was introduced to facilitate these initial voucher auctions where the formerly state-owned enterprises were “offered” to the general public. Although it was originally designed to serve only as a platform for the initial voucher auctions and not to support a full-fledged securities market, the RM-System soon extended its functions into the secondary market for these shares by matching buy and sell orders through a continuous electronic auction process that was accessible to both professional investors and the general public.\textsuperscript{58} At the same time as the RM-System was expanding its activities into the secondary trading markets, the Czech authorities re-opened the Prague Stock Exchange in April 1993 as part of an effort to create a better regulated trading platform for the development of a mature securities market.

Rather than carving out a niche for itself as the exclusive trading platform for sufficiently large and well-performing companies, the Prague Stock Exchange formulated fairly relaxed listing standards in order to compete with the RM-System for the same clients. While the RM-System supported the trading of about 2,000 companies, the Prague Stock Exchange had attracted over 1,700 listings by 1995. The end result of this competition for listings was the creation of a parallel market for securities in which many of the newly privatized companies traded their shares on both the RM-System and the

\textsuperscript{58} Vladimir Rudlovcak, \textit{Czech Capital Markets: Illusions and Disillusions}, in \textit{FINANCIAL TRANSITION IN EUROPE AND CENTRAL ASIA: CHALLENGES OF THE NEW DECADE} 154-55 (Bokros et al. eds., 2001). The RM-System has been analogized to alternative trading systems like the NASDAQ.
Prague Stock Exchange. Moreover, an active over-the-counter market became a third alternative for trading because the Czech Securities Center, where the dematerialized shares of the newly privatized companies were all registered, began allowing customers to bypass the two exchanges and record block trades among themselves directly onto its books. The trading infrastructure that was developed to facilitate the mass privatization program thus produced a highly fragmented market where customers could execute trades for shares in the same company on three distinct platforms.59

B. Czech Government’s “Hands-Off” Approach to Securities Regulation

The problems inherent in such a fragmented market for securities were only exacerbated by the legal framework that the Czech government enacted during the privatization process for the regulation of securities transactions. Led by Vaclav Klaus, the Finance Minister during the initial stages of privatization who later became Prime Minister, the Czech government adopted a laissez-faire approach with respect to economic policy during the transition period from communism to capitalism. In a speech from 1995, Klaus famously articulated his antigovernment, “hands-off” vision for economic reform in the Czech Republic:

We knew that we had to liberalize, deregulate, privatize at a very early stage of the transformation process, even if we might be confronted with rather weak and, therefore, not fully efficient markets … Conceptually it was – at least for me – rather simple: all you had to do was to apply the economic philosophy of the University of Chicago.60

59 According to one commentator, by 1996 only 3% of actual trades were executed on the Prague Stock Exchange as the RM-System and the over-the-counter market gained the lion’s share of the post-privatization trading business in the Czech Republic. See Eva Thiel, The Development of Securities Markets in Transitional Economies: Policy Issues and Country Experience, 70 FIN. MARKET TRENDS 111 (1998).

60 Shleifer et al, supra note 35 at 874.
The legislation on capital markets that the Czech Parliament passed during the early 1990s embodies this economic philosophy. The central document for the regulation of capital markets in the Czech Republic is the “Securities Act,” which was enacted in 1992 and became effective on January 1, 1993.\footnote{The other key documents for the regulation of capital markets in the Czech Republic are the Investment Companies and Investment Funds Act of 1992 and the Stock Exchange Act of 1992.} In the original legislation, the government opted not to establish an independent agency for the supervision of securities markets and instead charged the Capital Markets Supervisors Office in the Ministry of Finance with overseeing the regulation of securities markets. According to the authors of one study, the Ministry of Finance – which was headed by Klaus during this time – remained largely indifferent to the task of regulating securities markets.\footnote{See Shleifer et al, supra note 35 at 875.}

The regulation of financial intermediaries provided for by the Securities Act was particularly weak. Although the Securities Act required both individual brokers and brokerage houses to obtain licenses from the Ministry of Finance, these licensing procedures were essentially pro forma and brokers did not need to pass a substantive exam in order to gain trading privileges.\footnote{In their study of securities regulation in Poland and the Czech Republic, Shleifer et al, supra note 35, give a comprehensive overview of the 1992 Czech Securities Act. This paper relies heavily on their description for the analysis of the Securities Act in the following paragraphs.} In addition, the Securities Act did not require brokers to engage in “honest trading” or to act in the interests of their clients, an omission that severely curtailed the real authority of the Ministry of Finance to revoke or suspend the licenses of brokers and brokerage houses. Investment advisers went unmentioned in the Securities Act, thereby allowing those engaged in advisory activities for the public trading markets to escape regulation. With respect to exchanges, the Securities Act did
not give the Ministry of Finance any formal authority over stock exchange rules nor did it require public trading to take place on a stock exchange.

The Securities Act required only a minimum amount of disclosure from the issuers of securities. The relative weakness of the Czech mandatory disclosure system can best be seen by comparing it to the Polish regime for security offerings. Whereas in Poland the introduction of securities required both the permission of the regulator and a prospectus, the Czech Securities Act required neither. In Poland, issuers had to submit financial information on a monthly, quarterly, semiannual and annual basis. The Czech law only provided for the reporting of annual results. Finally, while Polish law required the disclosure of all material information, the Czech Securities Act only required issuers to disclose “significant adverse developments.”

In sum, the free-market philosophy of the Czech government led by Vaclav Klaus resulted in a Securities Act that allowed trading to occur in an environment relatively free from regulation and required issuers of securities to the public to disclose only a bare minimum of financial information. The weaknesses in the Securities Act were only compounded by the fact that, according to most observers, the office charged with enforcing the securities legislation, the Ministry of Finance, did not take its supervisory duties very seriously.

C. Structural Problems in Czech Securities Markets Due to Mass Privatization and “Hands-Off” Approach to Regulation

Initially, the Czech government’s dual strategy of rapid privatization and “hands-off” regulation paid off as shares prices rose and Czech securities markets attracted

64 For an extensive comparison of the Polish and Czech securities laws, see Id. at 877.
capital from foreign portfolio investors during a period of high optimism that lasted until 1995. Nevertheless, this one-time boost to the securities markets proved to be short-lived. After a series of scandals starting in 1996, most of which involved the expropriation (or “tunneling”) of corporate assets by managers of publicly-held companies and investment funds that held controlling stakes in those companies, both foreign portfolio investors and Czech citizens began to pull their money out of the Czech securities markets. For instance, one study of the Czech capital markets reports that foreign direct and portfolio investment dropped from $103 million in 1995 to $57 million in 1996 and then turned negative in 1997. Another author found a similar trend with respect to domestic investors – while over seven million Czech citizens had purchased shares through the voucher privatization auctions, the number of Czech shareholders had fallen to barely 5 million by 1999.

This withdrawal of funds from the Czech markets contributed to a precipitous decline in the value of shares traded on the Prague Stock Exchange. In 1996, the market capitalization of shares traded on the Prague Stock Exchange reached an end of the year high of roughly $18 billion, a figure that represented 32% of the Czech Republic’s Gross Domestic Product. By the end of 1997, however, the market capitalization of the Prague Stock Exchange had fallen to $12.7 billion, which corresponded to only 24.6% of

65 For a review of “tunneling” and the scandals surrounding this practice that came to light in the mid 1990s, see John Coffee, Institutional Investors in Transitional Economies: Lessons from the Czech Experience, in CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA. VOLUME 1 (Roman Frydman et al eds., 1996).

66 See Coffee, supra note 32 at 10.


68 See Shleifer et al, supra note 35 at 888 (Table VII).
the Czech GDP.\textsuperscript{69} The stock prices of the biggest Czech companies were hit particularly hard during this decline, as evidenced by the fact that an index of the leading 50 stocks on the Prague Stock Exchange fell by over 60% between 1995 and 1999.\textsuperscript{70} By 1998, when the Czech economy entered a general recession, public confidence in the Czech securities markets had largely been eroded.

The fall in the value of shares traded on the Prague Stock Exchange that began in 1996 revealed structural weaknesses in the Czech securities markets that the government’s “hands-off” approach to regulation had failed to address. As was mentioned above, the infrastructure that was introduced to facilitate the voucher privatization auctions had resulted in a securities markets where trading was fragmented among three separate platforms. In particular, this market fragmentation had deleterious effects on the price transparency of the Prague Stock Exchange. Since trading was not centralized and trading off the Prague Stock Exchange did not require contemporaneous price reporting, only the prices of those transactions that the trading participants wished to disclose were transacted on the Prague Stock Exchange and thus reported to the public trading market.\textsuperscript{71} In effect, traders were using the fragmented nature of the Czech securities markets and the Ministry of Finance’s tolerance for off-exchange trading to inflate stock prices on the Prague Stock Exchange. As a result, investors quickly grew skeptical that the reported prices on the Prague Stock Exchange reflected the real value of listed shares.\textsuperscript{72}

\textsuperscript{69} \textit{Id.}

\textsuperscript{70} Green, \textit{supra} note 67.

\textsuperscript{71} Coffee, \textit{supra} note 32 at 12.

\textsuperscript{72} \textit{Id.}
In addition to the problems associated with market fragmentation, the Czech securities market was also characterized by an oversupply of securities. In order to secure the most business from the proliferation of publicly-held companies during the mass privatization program, both the RM-System and the Prague Stock Exchange had adopted fairly relaxed listing standards. The Ministry of Finance essentially acquiesced to these permissive listing standards by refusing to assert jurisdiction over stock exchange rules in the 1992 Securities Act. Although there were over 2,100 and 1,700 firms admitted for trading on the RM-System and the Prague Stock Exchange respectively, the interest of active investors was concentrated on a very limited number of larger firms.\textsuperscript{73} Since the vast majority of stocks listed with the two exchanges were rarely, if ever, traded, many post-privatization investors found themselves locked into minority positions in “publicly-held” companies that had non-existent trading markets for their securities.

The lax disclosure requirements contained in the 1992 Securities Act also contributed to the continued looting of Czech firms through complex “tunneling” schemes. First, since there was no requirement of ownership disclosure in the Securities Act, the acquirers of large blocks could remain secret and exert control over the target company without alarming either the minority shareholders or regulators.\textsuperscript{74} Secondly, managers and majority shareholders could engage in self-interested transactions that stripped assets from the company without alerting third parties because the Securities Act

\textsuperscript{73} See Rudlovcak, \textit{supra} note 58 at 156.

\textsuperscript{74} See Shleifer et al, \textit{supra} note 35 at 886.
did not require disclosure of such transactions except perhaps in an annual report several months later.\footnote{Id.}

It had therefore become clear by 1996 that as a result of the interplay between mass privatization and the Klaus administration’s “hands-off” approach to regulation, Czech securities markets were plagued by serious structural problems associated with market fragmentation, non-transparency and illiquidity. In the wake of the stock market decline, political momentum gathered in the Czech Republic to reform the regulation of securities markets and legislation was passed in July 1996 that was designed to curb the most egregious abuses. The most significant provisions of this legislation included mandatory disclosure of block holdings, greater regulation of investment funds and restrictions on off-exchange trading.\footnote{Id.} Although these legislative measures did represent a strengthening of legal protections for minority shareholders, the continuation of tunneling scandals and the decline in the stock market created internal pressure on the Czech government to further reform the regulation of securities markets.


It was at this point in late 1996 and early 1997, as internal pressure had been mounting on the Czech government to reverse its approach to securities regulation, when the EU began to involve itself in the reform of the Czech securities markets. In December 1997, the Commission published its opinion on the Czech Republic’s application for membership to the EU. In the opinion, the Commission praised the

\footnote{Id.}
\footnote{Id.}
securities legislation passed by the Czech Parliament in 1992 as a “serious effort”
towards aligning Czech national law to EU legislation on securities and indicated that
Czech authorities had begun the process of implementing key directives such as the
public offer prospectus, capital adequacy for market risk, and investment services. The
Commission also noted that the securities reform measures passed in July 1996
represented a good step forward in curbing the manipulation of Czech securities markets
by strengthening the rights of minority shareholders as well as tightening the mandatory
disclosure regime. According to the Commission, then, Czech authorities had made
adequate progress on both the harmonization of Czech securities law to EU standards and
closing loopholes in the legislative framework for securities that recent scandals had
exposed.

Consistent with the White Paper’s emphasis on administrative capacity, however,
the Commission devoted a significant amount of attention in the opinion to criticizing the
regulatory structures charged with enforcing securities legislation and providing general
oversight for securities markets in the Czech Republic. The Commission first pointed out
that the office responsible for the supervision of Czech securities markets was not a
politically independent regulatory agency, but instead was located within the Ministry of
Finance. Although the Czech government had made assurances in 1997 that it would
establish an independent securities commission outside of the Ministry of Finance’s
direct authority, the Commission reported that the government was having difficulties in

77 See European Commission, supra note 54 at 44.
78 Id.
following through on this commitment. In addition to the lack of political independence, the Commission also faulted the securities supervision office in the Ministry of Finance for failing to develop a staff with the knowledge and skills necessary for providing satisfactory oversight of the Czech capital markets. Finally, the Commission noted that Czech securities markets were relatively illiquid and lacked transparency. Due to the findings in the July 1997 opinion, the Commission thus identified reform of securities supervision as a top priority for the Czech Republic in its bid for membership to the EU.

In 1998, the Czech government responded to internal pressure and the criticisms leveled by the Commission in its July 1997 opinion by finally enacting legislation that established an independent securities commission. Pursuant to the Securities Commission Act of 1998, the Czech Securities Commission (CSC) assumed responsibility for the supervision of securities markets from the Ministry of Finance on April 1, 1998. The Securities Commission Act further strengthened the supervision of securities markets by providing the new CSC with a broader range of enforcement powers than was previously exercised by regulators in the Ministry of Finance. In particular, the CSC was given the authority to approve or reject new share issues and to intervene more rapidly in the securities markets by issuing injunctive orders. In addition, the CSC could levy fines of up to $3 million to ensure more rigorous compliance with securities laws by the supervised entities. As part of an effort to attract

79 Id. at 43.

80 Id. at 105.

and retain more qualified staff, the Securities Commission Act also provided employees of the CSC with a salary substantially higher than what other civil servants in the Czech Republic were receiving at the time.  

Although it is difficult to attribute these improvements in securities regulation directly to critiques from the Commission in its July 1997 opinion, there is considerable circumstantial evidence to suggest that without such external pressure the Czech government would have been less likely to pass the legislation establishing the CSC. First, one cannot ignore the timing of the enactment by the government of the Securities Commission Act. The Commission’s July 1997 opinion noted that although the Czech government had agreed in principle to the establishment of an independent securities commission, Czech lawmakers had experienced many difficulties in getting this initiative off the ground. After the publication of the Commission opinion in July 1997, the Czech Parliament was able to pass a draft of the legislation establishing the CSC in November 1997 and the final legislation was enacted shortly thereafter in April 1998.

In addition to the close temporal relationship between the publication of the Commission’s 1997 opinion and the enactment of the Securities Commission Act, the Czech government’s continued display of hostility towards the idea of an independent securities regulator also indicates that external pressure from the Commission was a decisive factor in the creation of the CSC. Despite growing pressures within the Czech Republic to overhaul securities regulation and the continued slide of share prices on the Prague Stock Exchange, the Klaus-led government resisted the idea of an independent securities commission and delayed the legislative initiative on the CSC for many months.

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82 See Thiel, supra note 59 at 142.
before its ultimate adoption. Even though the Czech government grudgingly agreed to an independent securities commission in early 1998, it nonetheless effectively clipped the CSC’s wings by including provisions in the legislation that denied the commission the authority to issue binding regulations and made its budget dependent on funding from the state. The Czech government used its authority over the CSC’s funding to set the initial budget for the commission at the relatively low figure of $2.2 million per year. The fact that the Czech government delayed for months the establishment of an independent securities commission and then significantly watered down its authority by denying it regulatory powers and adequate resources suggests that the Commission’s negative assessment of Czech securities regulation in July 1997 was a key factor in overcoming resistance among Czech authorities to set up an independent securities regulator.

E. Role of Annual Progress Reports from Commission in Stimulating Further Reform of Czech Securities Regulation

Notwithstanding efforts by the Czech government to dilute the agency’s authority in the 1998 legislation, the CSC did represent a significant improvement over the former securities regulator office within the Ministry of Finance. Although the CSC had relatively scarce resources, it was nevertheless able to increase the number of staff devoted to securities regulation from 65 in the Ministry of Finance’s office in 1997 to 125 during the CSC’s first year of operation in 1998. From the very start, the CSC

83 Rocks, supra note 81.


85 Id.

began to address the structural problems of illiquidity and non-transparency in Czech securities markets that the Commission had cited in its July 1997 opinion by initiating an ambitious program of re-licensing for investment managers and de-listing of shares from the public trading markets. During its first year of operation, the CSC revoked the licenses of nearly 50% of the brokers, dealers and investment fund managers operating in the Czech securities markets.87 Brokers received particular attention from the CSC during this re-licensing process. One author reports that whereas 1486 brokers had been active in the securities markets in 1997, there were only 358 still in operation by mid-1999.88

The CSC was equally aggressive with respect to the de-listing of shares from the public trading markets. As part of this de-listing program, the CSC forced the Prague Stock Exchange to adopt stricter listing standards in 1999, which resulted in the de-listing of over 75% of its companies.89 The full impact of the stricter listing standards for admission to trading on the Prague Stock Exchange can be seen by comparing the 1716 listings on the exchange in 1995 when the standards were relatively low, with the 301 listings on the exchange after the implementation of the more stringent requirements in 1999.90 The CSC has continued to oversee the gradual elimination of shares from public trading markets. Indeed, the CSC reports that over a five year period from 1998 to 2002


88 See Green, supra note 67.

89 See Coffee, supra note 32 at 32.

90 See Green, supra note 67.
the combined number of listed securities issues on the Prague Stock Exchange and the RM-System has declined from 1772 to 240.\footnote{Czech Securities Commission, 2002 Annual Report 9, at http://www.sec.cz/download/Activity/ACT_Vyrocnizprava2_ENG5.pdf.}

In the first three annual reports on the Czech Republic’s progress towards accession that cover the period from 1998 to 2000, the Commission noted with approval the CSC’s success in imposing stricter requirements on both investment managers and securities issuers for access to the public trading markets. The Commission also published in the initial three progress reports the number of enforcement actions taken by the CSC, praising such efforts as crucial in increasing the level of compliance among brokers and issuers with their disclosure duties under Czech securities laws. Despite the accomplishments by the CSC in eliminating the weakest players from the securities markets and enhancing overall compliance, the Commission identified in these reports three specific problem areas with respect to the supervision of Czech securities markets.

The first problem area specified by the Commission concerned the structure of securities regulation in the Czech Republic. As noted above, the Czech government refused to give the CSC the power to issue binding regulations in the 1998 Securities Commission Act. The Commission found that this denial of regulatory authority to the CSC had created a bifurcated system of securities regulation in which the Ministry of Finance remained responsible for policy and rule-making while the CSC was in charge of market supervision and enforcement. According to the Commission, this division of responsibility was not an optimal arrangement for the regulation of Czech securities markets because the Ministry of Finance and the CSC had failed to effectively coordinate
their rule-making and supervisory functions. As a result, the Commission strongly encouraged Czech authorities to enhance the rule-making authority of the CSC.

The second weakness identified by the Commission was that the CSC remained financially dependent on the Czech Parliament for its annual budgetary needs. Although initial drafts of the 1998 Securities Commission Act had allowed the CSC to finance itself from fees paid by market participants, the Czech Parliament eventually decided that it would be preferable to take the operating funds for the agency out of the state budget. This decision to finance the CSC from the state budget had two important consequences for securities regulation in the Czech Republic. First, as the Commission notes, the fact that the CSC must rely on the Czech Parliament for its annual budget compromises the political independence of the agency and increases the degree to which regulation of securities markets will be subject to capture by whichever political party currently has a majority in Parliament. As one critical opponent of the Securities Commission Act remarked, “[u]nless such a regulatory body is financially independent, it can’t really regulate the market.”

Another problem with making the CSC financially dependent on the Czech Parliament was that it soon became clear that Parliament was not eager to fund the new agency. The CSC’s initial budget for 1998 was set at the relatively low figure of €1.8 million (approximately $2.2 million) and did not increase substantially over the next few

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93 Rocks, supra note 81.

94 See European Commission, supra note 86 at 17.

95 Rocks, supra note 81.
Given Parliament’s unwillingness to provide adequate funding, the CSC’s ability to supervise the securities markets was limited by the scarce resources that it had at its disposal. Due to the apparent difficulties created by state funding, the Commission recommended that the Czech government turn the CSC into a self-financed regulatory body.

The final problem area identified by the Commission was that despite recent reform measures, the CSC had yet to adequately address the lack of transparency in the public trading markets. According to the initial progress reports, trading was still fragmented among three distinct markets (Prague Stock Exchange, RM-System and OTC) and such market fragmentation led to divergent prices for the same stock as well as continued schemes involving price manipulation. In the progress reports, the Commission urged Czech regulators to adjust their supervisory framework to correct these structural problems of market fragmentation and non-transparency of price information.

In sum, the first three progress reports filed by the Commission recognize that the creation of the CSC and the subsequent reform measures undertaken by the agency represent significant improvements in the regulation of Czech securities markets. The reports, however, found that the supervisory framework for securities suffered from three major structural weaknesses: the CSC lacked the power to issue regulations, remained financially dependent on the Czech Parliament and had yet to resolve issues of market fragmentation and price transparency in the securities markets. Given the importance of

96 See European Commission, supra note 87 at 65.
97 Id. at 24.
these problems for securities regulation, the first three progress reports all suggest that the strengthening of securities supervision remain a key short-term priority for the accession process in the Czech Republic.

Both the Czech government and the CSC were responsive to the concerns over securities supervision raised by the Commission in the progress reports. In addition to passing a series of amendments to the Securities Act in 2001 that further aligned Czech securities laws with EU directives, the Czech Parliament adopted changes to the Securities Commission Act in July 2002 that provided the CSC with the authority to issue secondary legislation.\(^98\) Since the CSC has now assumed the lead on rule-making for securities markets, many of the problems associated with the gap between legislative and supervisory functions that existed under the bifurcated regulatory structure have been eliminated. The CSC has recently used its new authority to promulgate regulations to implement key aspects of the amended Securities Act, including the issuance of a detailed set of internal control requirements for brokerages firms that is designed to improve investor confidence in the securities markets.\(^99\)

Czech policymakers have also focused their efforts on reducing fragmentation in the trading markets for securities. An important component of the Czech strategy to reduce market fragmentation was to channel as many trades as possible onto a more tightly regulated Prague Stock Exchange. In response to both market forces and pressure from Czech regulators, the Prague Stock Exchange adopted a number of reforms to instill confidence among investors in its trading environment. To provide investors with higher

\(^{98}\) Czech Securities Commission, *supra* note 91 at 16.

\(^{99}\) *Id.*
liquidity and price transparency, the Prague Stock Exchange introduced in 1998 a continuous, price-driven trading module for heavily traded stocks called “SPAD” to replace its former trading system that was order-driven.\textsuperscript{100} Between 1999 and 2002, the Prague Stock Exchange revised its internal legislative framework and rules of trading to bring them in line with EU standards, a process that resulted in more stringent listing standards and heightened disclosure requirements for issuers.\textsuperscript{101}

At the same time as the Prague Stock Exchange was restructuring its trading infrastructure and internal legislative framework, the Czech government passed a number of measures aimed at reducing the number of off-exchange trades. Whereas the Prague Stock Exchange had always been authorized as an exchange, the RM-System had received special permission under the original Securities Act to operate like a broker and had been regulated as such. In January 2001, however, the Czech government required the RM-System to be regulated in the same manner as the Prague Stock Exchange and thus assume similar regulatory responsibilities such as the surveillance of trading and the adoption of stricter listing standards. It appears that by subjecting the RM-System to full regulation as an exchange, the Czech authorities have been able to decrease significantly the RM-System’s market share of public trading in securities.\textsuperscript{102} While the RM-System accounted for over 20% of all public trades and had 2165 listed securities in 1996, those figures had fallen to less than 2% of public trading and only 312 listings by the end of


\textsuperscript{101} \textit{Id.}

\textsuperscript{102} The Czech Securities Commission defines “public trading” as those trades in securities that occur on either the Prague Stock Exchange or the RM-System.
Due to the initiatives described above, the Prague Stock Exchange has become, in effect, the only market for the public trading of securities in the Czech Republic.

Another important step in reducing market fragmentation occurred in 2001, when an amendment was passed to the Securities Act that required members of the Prague Stock Exchange to report all trades to the exchange’s trading system, including off-exchange trades. Although the over-the-counter market for securities still accounts for more than 50% in volume of all securities traded in the Czech Republic, the reporting requirement for off-exchange trades is likely to decrease any discrepancies in the price of the same security between the Prague Stock Exchange and the over-the-counter market. The end result of the measures undertaken by Czech regulators to reduce market fragmentation is that despite the fact the over-the-counter market remains the most popular trading platform for securities, the regulatory framework has increased transparency by channeling most of the price information on listed securities to the Prague Stock Exchange.

The one area where Czech regulators have resisted the Commission’s proposals for reform is the financial independence of the CSC. Notwithstanding the Commission’s repeated calls in its progress reports for a regulatory body that is self-financed, the CSC continues to get its annual funding from the state budget and there is no evidence that the Czech government is considering a change. Parliament has been unwilling to expand the

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103 See Czech Securities Commission, supra note 100 at 8.


105 The Czech Securities Commission reports in 2002 that while transactions performed outside the public trading markets amounted to nearly 1.9 billion Czech koruna, trades occurring on the Prague Stock Exchange and the RM-System amounted to around 1.8 billion Czech koruna. See supra note 100 at 32-3.
funding for the agency. Indeed, the CSC’s budget has remained flat over the past few years at an annual figure of around $3 million despite the fact that improvements to the supervisory framework have increased the agency’s workload and responsibilities. The Commission did find in its 2002 progress report that the CSC had attained a sufficient level of staffing.\footnote{See European Commission, 2002 Regular Report on Czech Republic’s Progress Towards Accession 60, at http://europa.eu.int/comm/enlargement/report2002/cz_en.pdf.} According to a 2001 IMF report, however, the fact that the CSC suffers from severe resource limitations has prevented the agency from developing the requisite technical expertise among that staff.\footnote{IMF, supra note 104 at 30.} It appears, then, that the reluctance (or perhaps inability) of the Czech government to increase the level of funding for the CSC has held back the agency in developing its capacity to supervise the Czech securities markets and that a self-financed regulatory body may indeed represent an improvement over the current system.

In conclusion, the run-up to accession during the years 1997 to 2003 witnessed radical changes in the structure of securities regulation in the Czech Republic. Within that short period of time, the Czech government reversed course on its “hands-off” approach to the regulation of securities markets and created an independent securities commission with significant enforcement and regulatory powers. Oversight by the EU in the form of annual progress reports from the Commission appears to have been crucial in convincing the Czech government both to establish an independent securities commission and then to strengthen the supervisory powers of that commission. The main evidence to suggest a link between EU oversight and regulatory development in the Czech Republic is a conspicuous pattern that recurs throughout the accession process in which the...
Commission points out a problem with securities regulation in its annual report and Czech officials subsequently adopt measures designed to address that same problem. Appendix B provides a summary of the major recommendations concerning securities regulation that the Commission made both in its initial July 1997 opinion and in the annual reports as described below as well as the remedial action taken by Czech officials during the oversight period. To be sure, there were factors within the Czech Republic like a recession and prolonged slide on the Prague Stock Exchange that created internal pressure on the government to reform the securities markets. In addition to increasing the already existing pressure within the Czech Republic, what EU oversight seems to have added to the reform movement is to focus Czech authorities on specific weaknesses in the supervision of securities markets and to give a compressed time horizon (May 2004) for authorities to correct those weaknesses.

It should be noted that the accession process has not stimulated much growth in the Czech securities markets. The public trading markets for equity securities remain largely illiquid, as evidenced by the fact that only 7 stocks currently trade in the SPAD system that handles the most liquid securities on the Prague Stock Exchange. Furthermore, Czech companies do not use the issuance of equity securities as a regular source for corporate finance. According to the CSC, debt securities dominate the Czech capital markets, representing about 89% of the total volume in public trading. The vast majority of these debt securities are government and bank bonds, while corporate bonds rarely trade on the Czech markets. These rather bleak figures indicate that the accession process and the related oversight by the EU have not succeeded in shifting the Czech

\[108\ See Czech Securities Commission, supra note 100 at 12.\]
economy from a reliance on bank financing to an equity-based financial sector or to
directly stimulating growth in Czech securities markets. What the accession process has
achieved, however, is overcoming political resistance in the Czech Republic to establish a
strong supervisory framework that most commentators agree is an essential pre-condition
to the development of an active securities market. If the Prague Stock Exchange does
eventually mature into an important source of equity financing for Czech companies, then
the regulatory reforms enacted as a result of the accession process will rightly be seen as
the crucial first step that enabled such development.

109 Id. at 8.
Part IV: Hungary and the Limits of Regional Integration for Regulatory Development in the CEECs

While an examination of accession in the Czech Republic reveals some of the possibilities that EU enlargement can offer to candidate countries when the processes of regional integration and securities market development coincide, this section will use the Hungarian experience to illuminate the limitations of the EU’s approach to enlargement when such processes diverge. It may seem counterintuitive to analyze enlargement in Hungary as an example of the limits of regional integration for capital market development, insofar as many commentators have hailed the Hungarian financial sector as one of the most sophisticated in the region and Hungarian authorities have shown a willingness throughout the enlargement stages to experiment with regulatory reforms. Yet it is precisely these innovations in Hungary’s financial regulation that expose a fundamental gap between the regulatory structures that are best for stimulating growth in the EU’s internal market and the optimal regulatory structures for a transition economy. This section, then, will use the success of financial sector reform in Hungary to highlight the limits of what the process of EU integration can achieve with respect to the development of securities markets in the CEECs.

A. Privatization and the Early Development of an Infrastructure for Securities Markets

Like in the Czech Republic, there is a long history of stock exchange activity in Hungary. The Budapest Stock Exchange first opened in 1864 and soon developed an active trading market for bills of exchange and foreign currency. As with other stock

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11 Philbrick, supra note 55 at 571.
exchanges throughout Central and Eastern Europe, World War II ended all operations on
the Budapest Stock Exchange and securities activity in Hungary remained dormant until
the early 1980s.

At the beginning of the 1980s, Hungary became one of the first (soon to be
former) Soviet satellites to liberalize its financial sector when it started experimenting
with market economics by outlining rules for the issuance of bonds.\footnote{Id. at 572.} There soon
developed in Hungary a nascent “market” for fixed-rate corporate bonds, which carried
the Hungarian government’s guarantee and all contained the exact same interest rate.
After the global stock market crash in 1987 and subsequent rise in inflation rates,
investors became less interested in the Hungarian bond market. As inflation continued to
rise, the Hungarian government itself started to tap the domestic capital market by issuing
treasury bills, which replaced corporate bonds as the major type of security issued on the
Hungarian capital market.\footnote{Id.} The Hungarian financial sector was further liberalized in
1987 with the introduction of a two-tiered banking system that split the functions of the
central bank and commercial banks.\footnote{Lannoo, supra note 8 at 87.} Finally, 41 members re-established the Budapest
Stock Exchange in July 1990 as the first major step towards creating a modern securities
market.\footnote{Philbrick, supra note 55 at 572. The Budapest Stock Exchange was the first stock exchange to reopen in
the region. Once the exchange reopened, government securities dominated the market by accounting for
90% of all trading on the exchange.}

Hungarian authorities adopted a similarly progressive approach towards the
regulation of the country’s newly liberalized capital market. Hungary’s basic securities
law, referred to as the Hungarian Securities Act, went into effect on February 1, 1990, well before the Budapest Stock Exchange reopened for trading. The main provisions of this act establish a mandatory disclosure regime for securities, in which public offerings must include a prospectus that sets forth information regarding (among other things) management, business operations, financial data not more than six months old and certified by auditors, and risk factors.  

In contrast to the Czech government’s unwillingness to cede supervisory control over securities markets from the Ministry of Finance, the Hungarian Securities Act also created an independent securities commission – the State Securities Supervision Board – that was responsible for ensuring the adequacy of prospectus disclosure, issuing permits for public offerings, licensing stock traders, and supervising overall market activity on a continuous basis. The only feature missing from the State Supervision Board that is characteristic of most Western securities supervisors was the authority to issue binding regulations, a power that the Hungarian Ministry of Finance reserved for itself. Unlike the early Czech securities legislation, the Hungarian legal framework for securities thus created a fairly stringent mandatory disclosure regime with independent regulatory oversight that resembled the securities regulation of more sophisticated Western markets.

In addition to progressive reform packages designed to liberalize markets and introduce meaningful regulatory oversight for securities transactions, the approach to privatization taken by Hungarian authorities represents another critical factor in the rapid development of a relatively advanced financial sector in Hungary. What is most

\[116\] Id. at 598.

\[117\] Id. at 602.
significant about privatization in Hungary, and what sets it apart from privatization in other CEECs, is the extent to which the Hungarian government relied on sales to foreign investors, especially with regard to the financial sector. Indeed, Hungary was the first CEEC to introduce sales to foreign strategic investors on a large scale as a part of its privatization program. \textsuperscript{118} This strategy was particularly pronounced within the financial sector, as Hungary adopted a liberal approach to attracting foreign direct investment in its move to both privatize and modernize the country’s financial institutions.\textsuperscript{119} As a result of this method of privatization, by the mid 1990s foreign strategic investors came to control most large Hungarian banks and foreign capital assumed a dominant role in the overall banking system for Hungary. The trend of foreign ownership has continued up to the present and extended into the entire financial sector, with the IMF reporting in 2002 that foreign strategic investors own nearly 70\% of the banking system, 90\% of the insurance sector and 70\% of investment service providers in Hungary. \textsuperscript{120} According to Hungary’s current financial regulator, foreign ownership has strengthened the Hungarian financial sector because these investors have imported management strategies and best practices from Western Europe into Hungary and thereby increased the overall level of sophistication within the Hungarian financial markets.\textsuperscript{121}

The Hungarian government’s strategy of combining meaningful oversight of capital markets with sales of financial institutions to strategic foreign investors had paid

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\textsuperscript{118} Lannoo, supra note 8 at 88.

\textsuperscript{119} Bokros, supra note 110 at 16.


\textsuperscript{121} See Hungarian Financial Supervisory Authority, supra note 11 at 7.
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off by the mid 1990s as multilateral organizations began recognizing Hungary for the soundness and sophistication of its financial sector. In its annual assessment of regulatory reform in transition economies for 1996, the European Bank for Reconstruction and Development (EBRD) gave Hungary a score of 3 (out of a possible 4+) on the strength of its securities market infrastructure.\footnote{European Bank for Reconstruction and Development, \textit{Transition Report 11} (1996).} This rating from the EBRD established Hungary as a leader among the CEECs in the area of financial sector reform.

The European Commission was similarly impressed with the Hungarian system of financial regulation in its July 1997 opinion on Hungary’s application for EU membership. The Commission noted in the opinion that although the Hungarian financial markets were not as developed as those in the current EU member states, the progress made to date had been impressive.\footnote{European Commission, \textit{Agenda 2000 – Commission Opinion on Hungary’s Application for Membership of the European Union} 49, at http://europa.eu.int/comm/enlargement/dwn/opinions/hungary/hu-op-en.pdf.} In particular, the Commission found that by 1997 most of the major EU directives on securities had already been adequately transposed into Hungarian national law and that the supervision of securities markets in Hungary was functioning at a level comparable to EU standards. Whereas the Commission’s 1997 opinion on the Czech Republic identified the improvement of securities supervision as a key short term priority for accession, the Commission appeared to be relatively satisfied with the regulation of securities markets in Hungary and did not offer in the opinion any specific recommendations for further regulatory development within the financial sector.
B. The Consolidation of Financial Supervision in Hungary

Despite the fact that the Commission’s opinion did not single out financial regulation as a priority for Hungary during the accession process, Hungarian authorities enacted a series of ambitious reforms between 1997 and 2000 that were designed to further strengthen supervision over the country’s financial sector. In response to a rise in the number of financial conglomerates operating in the Hungarian capital market, the 1996 Law on Credit Institutions established the basic framework for the consolidated supervision of banks and, in accordance with this framework, merged the formerly separate bank regulator and State Securities Supervision Board into a single supervisory institution called the Hungarian Banking and Capital Market Supervision.\(^{124}\)

Notwithstanding the introduction of consolidated supervision in 1996, weaknesses in financial supervision were revealed in 1997 when a run on customer accounts at Postabanka – then Hungary’s second largest retail bank – exposed a number of underlying problems with financial management at the bank and eventually forced the government to sponsor a €600 million bail-out plan to save the bank.\(^{125}\) A further need for regulatory reform arose in 1998, when an amendment to the law on Credit Institutions permitted banks to provide banking and investment services under one roof, thereby creating the possibility for universal banking in the Hungarian financial markets.

Hungarian authorities reacted quickly to align supervision with recent developments in the financial markets. In April 2000, the Hungarian Parliament enacted


the Law on Single Supervision that merged the Hungarian Banking and Capital Market Supervision, Insurance Supervision and Pension Supervision into a single entity – the Hungarian Financial Supervisory Authority (HFSA) – as part of an effort to improve supervision over the financial groups that had emerged during the mid 1990s and that were only likely to grow after the introduction of universal banking in 1998. By April 2000, Hungary had thus completed the consolidation of financial supervision that had begun just three years earlier with the merging of banking and securities regulators.

The reforms that consolidate financial supervision in Hungary have been well-received by the international community. It is interesting to note that this process of regulatory consolidation largely coincided with a rapid growth on the Budapest Stock Exchange. While in 1996 there were 45 companies listed on the Budapest Stock Exchange with a combined market capitalization of 852 billion Hungarian forint, by 2000 those numbers had increased to 64 listed companies with a market capitalization of 3,393 billion forint. 126 Although much of this growth can be attributed to the privatization of state-owned enterprises, there is some evidence that improvements in regulation contributed to the rise in shares prices on the Budapest Stock Exchange during this period. For instance, one author reports that after “tunneling” scandals in the Czech Republic led to a decline in share prices, foreign investors began in 1996 and 1997 to shift their money from Czech securities markets to the better-regulated markets in Warsaw and Budapest. 127 Another indication of the relative effectiveness of these regulatory reforms


in Hungary is that foreign investors have remained active on the Budapest Stock Exchange and now account for around 50% of all trades executed on its floor.

In addition to support from foreign investors, Hungary has also garnered praise from multilateral institutions for its efforts to consolidate financial supervision. In its 1999 evaluation of transition economies, the EBRD rated financial regulation in Hungary (along with that in Poland) as the most effective among the CEECs. For its part, the IMF has referred to the introduction of consolidated supervision as “an additional safeguard for preserving the soundness of [Hungary’s financial] system” and “a most welcome innovation in light of the dominance of large financial groups in the country.” The European Commission has largely agreed with the assessments of the EBRD and the IMF, concluding in its 2002 Progress Report that the establishment of the HFSA has strengthened the quality and effectiveness of the supervisory framework for the Hungarian financial markets.

C. Analysis of the Role of EU Oversight in the Hungary’s Consolidation of Financial Supervision

Given the importance that both foreign investors and multilateral institutions have attached to Hungary’s adoption of a consolidated system of financial supervision, it is perhaps surprising that the EU does not appear to have played much of a role in the enactment of these reforms during the run-up to accession. The Commission made no recommendation in the July 1997 opinion and 1998 Progress Report that Hungary

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128 Kim, supra note 126 at 89.
130 IMF, supra note 120 at 21.
consolidate, or further consolidate, its framework for financial supervision. Instead, the annual progress reports indicate that the Commission assumed a passive role with respect to the consolidation of supervision in Hungary, in which it merely reported on the regulatory reforms and offered a few generalized suggestions for improving the new HFSA like increasing training for staff and gaining financial independence from the Ministry of Finance. Since there is no evidence in public documents to suggest that the EU took an active position with respect to the creation of the HFSA, it appears that the decision to consolidate financial supervision came largely at the national level as Hungarian authorities sought to harmonize regulatory structures with changes in the financial marketplace. Domestic concerns, and not pressure from the Commission in Brussels, were thus the driving force behind Hungary’s move towards consolidated supervision.

The passive role taken by the EU with respect to consolidated supervision in Hungary is indicative of the Commission’s overall strategy for overseeing regulatory development during the accession process in the CEECs. According to the White Paper and subsequent documents on enlargement, the CEECs must have “adequate” capacity to administer EU legislation as a prerequisite for gaining accession. The Commission seems to have operationalized this requirement into a standard of review pursuant to which the Commission assesses the overall effectiveness of regulatory institutions adopted by the CEECs and offers recommendations for improving those institutions as they exist. The Commission, however, seems to have interpreted the “adequacy” standard for regulatory development as precluding it from dictating to the CEECs a

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particular structure or institutional design for financial regulation. Hungary and the Czech Republic are excellent illustrations of how the Commission has implemented the adequacy standard with respect to financial regulation. On the one hand, the Czech case demonstrates that the Commission is willing to insist that the CEECs have in place an independent regulatory agency with the requisite expertise to oversee securities markets. On the other hand, the fact that the EU was not an important factor in the creation of the HFSA is an example of how the Commission is more hesitant in prescribing an optimal structure for financial supervision in the CEECs.

There are important consequences for both the EU and the CEECs from the decision by the Commission to evaluate the adequacy of, but not optimal structure for, financial regulation in the acceding states. Two basic models currently exist for the regulation of securities markets. The traditional approach to securities regulation is to establish a specialized agency that is assigned jurisdiction over transactions that involve securities, like the SEC in the United States. The second approach is to consolidate all financial regulation – typically banking, securities, insurance and pension funds – into a single institution with jurisdiction that extends over the entire financial marketplace.\footnote{For an analysis of the traditional versus consolidated approach to financial regulation, see Giorgio Di Giorgio & Carmen Di Noia, *Financial Market Regulation and Supervision: How Many Peaks for the Euro Area?*, 29 Brooklyn J. Int’l. L. 463 (2003).}

The most prominent example of the consolidated approach to financial regulation is the Financial Services Authority in Great Britain. Given the freedom to choose between these two approaches to securities regulation, most of the CEECs initially opted to follow the specialized regulator model. By early 2000, Hungary was the only CEEC to have

adopted a fully consolidated approach to financial regulation. Since that time, Lithuania, Estonia and the Slovak Republic have merged their financial regulators into a single supervisory institution. Of the four largest securities markets in the CEECs, however, Hungary remains the only country with consolidated financial supervision. The Czech Republic, Poland and Slovenia have all decided to stay with the specialized regulator model for securities. One can therefore conclude that securities regulation in the CEECs has been, and continues to be, weighted towards the specialized agency approach.

The preference among CEECs for specialized securities regulators is at odds with a recent trend among EU member states towards consolidated financial supervision. Since 1997, the vast majority of EU member states have opted to move their respective frameworks for financial supervision towards the single regulator model. Indeed, as of April 2004 it appears that only Portugal, Italy, Spain and Greece have resisted this trend towards consolidation and retained their specialized securities regulators. This gap between financial regulation in the CEECs, where the specialized agency model remains the dominant approach, and in the EU, whose member states have recently moved towards the single regulator model, has created the potential for significant problems once the CEECs join the EU internal market. In its 2001 report, the Lamfalussy Committee identified variations in national regulatory structures as a significant impediment to the creation of a well-functioning internal market for securities. One

133 See Lannoo, supra note 8 at 101.
134 See Di Giorgio & Di Noia, supra note 132 at 467.
can only assume that the Lamfalussy Committee’s emphasis on regulatory convergence has been a major reason why in the past few years most of the member states have finally consolidated their supervision of banking, securities and insurance into a single regulatory institution.\footnote{Another important reason for this trend is that a single financial regulator can provide better supervision of the increasing number of financial conglomerates operating within the EU. See Karel Lannoo, Financial Sector Regulation in CEECs and EU Accession, in EUROPEAN UNION ACCESSION: OPPORTUNITIES AND RISKS IN CENTRAL EUROPEAN FINANCES 302 (World Bank, 2000).} Nevertheless, the impending accession of the CEECs, which have gravitated towards specialized securities regulators, threatens to disrupt this process of regulatory convergence among member states and, if the Lamfalussy Report is correct, may provide a further obstacle to financial market integration in the EU. It is therefore surprising that, given the recent calls from Brussels for regulatory convergence, the Commission has not been more aggressive in persuading the CEECs to adopt the single financial regulator model when it had the most leverage to do so during the accession process.

An analysis of the rationale behind the decision by many of the CEECs to follow the specialized agency models reveals a fundamental tension between what is required for increased financial market integration at the EU level – that is, regulatory convergence towards consolidated supervision – and what officials in the CEECs believe is the optimal regulatory model for stimulating growth in their emerging securities markets. It appears that a consensus has developed among many CEEC officials that a specialized securities regulator is the appropriate model for a transition economy. In a June 1999 speech at the European Borrowers Network seminar, Jaroslaw Kozlowski, the deputy chairman of the Polish Securities and Exchange Commission, stated that supervisory
specialization is the best way to build confidence among investors in the securities markets of an emerging economy.\textsuperscript{137} A similar idea was put forth by the chief executive director of the Czech National Bank Advisory Council, who in an article from 2000 cited the fact that different financial segments and the regulatory agencies overseeing them are at varying stages of development as a major reason why the Czech Republic should remain with the specialized agency model for financial regulation.\textsuperscript{138}

There is some empirical evidence to support these claims by CEEC officials that a specialized agency is the optimal regulatory structure for a country with an emerging securities market. In a study of the relationship between securities laws and financial development in transition economies, one group of scholars has found that the mere enactment of legislation that strengthens shareholder rights has little effect on growth in securities markets and that what really matters for stock market development is that the legislation is adequately enforced by national authorities.\textsuperscript{139} The one exception to this general rule, however, was the enactment of legislation in the transition economies that is designed to protect the integrity of the stock market. Included in this category was legislation that establishes an independent securities regulator and that prohibits self-dealing and insider trading. The authors of the study conclude from this data that the enactment of such laws sends a signal to investors that the state is seriously committed to making securities markets work.\textsuperscript{140} It is difficult to draw any strong conclusions from

\textsuperscript{137} \textit{Id.}\n

\textsuperscript{139} See Pistor et al, \textit{supra} note 34.

\textsuperscript{140} \textit{Id.} at 15 (footnote 12).
this study on the comparison between a specialized securities regulator and consolidated supervision, insofar as the data set used by the authors contains a number of different rules and does not appear to include legislation that consolidates financial supervision into a single regulatory institution. Notwithstanding the incomplete nature of its data, the study does lend a certain credence to the intuition, apparently shared by many officials in the CEECs, that a specialized agency may send a clearer signal than a single financial regulator to investors that national authorities are serious about protecting the integrity of domestic securities markets.

Further academic studies on the question of whether consolidation supervision is the appropriate model for emerging securities markets have offered additional support for the decision by CEECs to follow the specialized agency model. In one recent paper, Michael Taylor and Alex Fleming evaluate the experience of three Scandinavian countries (Denmark, Norway and Sweden) with the single regulator model in an attempt to determine whether such a system of financial supervision can deliver benefits to countries with relatively small economies. The authors point out that although much critical attention has been focused on the decision by the U.K. to adopt a single financial regulator in 1997, these three countries had begun to consolidate financial supervision as early as 1986 and can therefore provide a considerable body of evidence with which to assess the relative effectiveness of this regulatory model. Appendix C provides data on


142 While Norway was the first to adopt a variant of the single regulator model in 1986, Denmark followed with its own series of consolidating reforms in 1988 as did Sweden in 1991. Id. at 145-46.
the relative sizes of the economies in the three Scandanivian countries and in the Czech Republic and Hungary.

Two main justifications emerge from the decisions by Danish, Norwegian and Swedish authorities to consolidate financial supervision into a single regulatory agency. The first is the conventional rationale, cited by all countries (including Hungary) which have adopted an integrated approach, that a single financial regulator can provide better supervision of financial conglomerates because the regulatory structure mirrors the underlying integration of financial markets. The second justification mentioned by the Scandinavian countries, however, is more specific to smaller nations that have fewer resources available to regulators. Taylor and Fleming found that officials from all three countries argued that a single financial regulator would be able to achieve significant economies of scale over a system based on specialized agencies. The authors refer to this notion that a single financial regulator allows smaller countries to maximize scarce human and administrative resources as the “small country argument” for consolidated financial supervision.

The findings from the Taylor and Fleming study suggest that it is easier for smaller countries to achieve benefits from the economies of scale provided by a single regulator than it is to realize gains from this model on the supervision of financial conglomerates. Evidence from the Danish, Norwegian and Swedish experience indicates that consolidation of supervision into a single institution can improve the quality of resources devoted to financial regulation. Despite the fact that it is difficult to measure efficiency gains in any meaningful sense for administrative agencies, all the officials

\[\text{Id. at 151.}\]
from the three countries interviewed by Taylor and Fleming agreed that they have been able to achieve more effective regulation on the basis of limited resources than would have been the case had their regulatory agencies remained separate.\textsuperscript{144} In addition to this anecdotal evidence on gains from an economy of scale, Taylor and Fleming also found that due to their increased political clout, the single financial regulators from Denmark, Norway and Sweden have been more successful than specialist agencies in securing from the government the funding needed to effectively supervise the financial markets.\textsuperscript{145} Finally, the creation of a single financial regulator of sufficient size to offer a higher degree of career progression for its staff seems to have contributed to overcoming problems of staff recruitment and retention at the formerly separate regulatory agencies in these countries.\textsuperscript{146} Better staff recruitment and retention has, in turn, enabled the single financial regulators for Denmark, Norway and Sweden to develop a critical mass of professional staff with the requisite technical expertise. On the basis of these improvements in the quality of resources available to financial regulators, Taylor and Fleming conclude that there is much validity to the “small country argument” that the consolidation of financial supervision can deliver the benefits of a regulatory economy of scale.

On the other hand, the Taylor and Fleming study finds that in practice it has been difficult to translate the theoretical advantages of a single regulator into a more effective

\textsuperscript{144} Id. at 162.
\textsuperscript{145} Id. at 163.
\textsuperscript{146} Id.
system of supervising financial conglomerates. As Taylor and Fleming note, many of these difficulties can be attributed to administrative reasons:

When the Scandinavian integrated agencies began their operations most did so by preserving their predecessor agencies as separate divisions within the new organization. This had the disadvantage of preserving a sense of separate identity and culture among these different divisions, with the result that in a number of cases they seem to have communicated no more successfully than did separate agencies. On the other hand, more recent attempts to reorganize the integrated agencies along more “functional” lines (for example by distinguishing between larger, systemically important institutions and smaller, non-systemic institutions) have resulted in complex internal matrix management structures.\textsuperscript{147}

Given the realities of restructuring formerly separate administrative bodies, Taylor and Fleming conclude that it is too early to say whether consolidated supervision will be able to provide for smaller countries the more effective oversight of financial conglomerates that the theory behind this model predicts.

The early experience in Hungary with merging two separate financial regulators offers further evidence of how the practical difficulties in an administrative restructuring can prevent a single regulator from realizing potential gains in the supervision of financial conglomerates. One observer of financial regulation in Hungary reported that there had been problems integrating banking and securities supervisors in 1997 because of the different organizational criteria and supervisory standards used by the separate agencies in the regulation of their respective sectors.\textsuperscript{148} Since the two supervisory authorities continued to use different data collection and reporting systems after the merger, they began operating as two relatively independent supervisors under a single

\textsuperscript{147} \textit{Id.} at 164.

organizational umbrella.\textsuperscript{149} It was not until 2003 that, with the help of a PHARE grant from the EU, the HFSA completed the development of a data collection system that fully integrates the information technology of the formerly separate financial supervisors.\textsuperscript{150} Although the HFSA is still in its infant stages, the evidence from the experience thus far in Hungary with integrated supervision indicates that the benefits of a single regulator for supervising financial conglomerates can only be realized after a lengthy and expensive restructuring process. In the near term, the expenses involved in such an administrative restructuring may offset any efficiency gains from consolidating separate agencies into a single institutional framework.

Taylor and Fleming offer two further caveats for small countries that are considering a system of consolidated financial supervision. First, Taylor and Fleming note that in economies like the CEECs where banks have dominated, banking supervision has been a priority for governments and thus has emerged as the strongest financial supervisory agency in those countries. There is a fear among officials in the CEECs that the merger of banking supervision with weaker regulatory agencies will have adverse effects on the supervision of financial markets. Taylor and Fleming explain such fears as follows:

First, the weaker elements in the integrated agency will “dilute” the strength of the stronger (banking) element. Second, significant numbers of banking supervisory staff may leave the integrated agency (to join commercial banks where the pay is higher) rather than take a lowering of status. Finally, a dangerous vacuum of authority could arise in the new agency until it has established its credibility.\textsuperscript{151}

\textsuperscript{149} Id.


\textsuperscript{151} Taylor & Fleming, supra note 141 at 166.
Given the problems associated with the integration of two regulators with varying levels of development and sophistication, Taylor and Fleming suggest that a prerequisite for the consolidation of financial supervision in such bank-dominated economies is strong senior management capable of making the necessary adjustments at the new integrated agency. Since financial supervision has been in existence for less than 15 years in the CEECs, one can therefore question whether senior management at these regulatory agencies have built up the experience and reputational capital that is necessary to guide their agencies through such a radical restructuring process.

Finally, Taylor and Fleming warn that a single financial regulator involves a significant concentration of power. According to Taylor and Fleming, it is important to ensure that this concentration of supervisory authority cannot be used to serve political, rather than legitimate regulatory, purposes. The danger that a single financial regulator will be “captured” by political interests seems to be particularly acute within the CEECs, where financial regulation is a relatively new concept and financial supervisory have only begun to carve out a regulatory space for themselves that is recognized by all national authorities as independent from the political arena.

Evidence from both the Taylor and Fleming study on single financial regulators in the Scandinavian countries and the early experience in Hungary with integrated supervision lends support to the belief held by many CEEC regulators that a specialized agency is the more appropriate model for an economy with an emerging securities market. Given the expense involved in restructuring financial supervision as well uncertainty about whether integrated supervision will even work in transition economies, a more cost
effective solution for supervising financial conglomerates and eliminating any regulatory
gaps is for CEECs to enhance coordination among separate financial supervisors. From a
purely developmental perspective, then, the Commission seems to have taken the correct
approach in its oversight of regulatory development by not requiring the CEECs to follow
the trend towards consolidated supervision among member states. Nevertheless, such an
approach does not appear to be consistent with the goal of regional integration, since it
has produced regulatory divergence among the candidate countries that is likely to have
adverse consequences for the Lamfalussy process. The wide disparity between the level
of securities market development in the CEECs and the current member states has thus
given rise to a fundamental limitation on what the Commission could achieve with
respect to regulatory development during the accession process. The member states with
more advanced securities markets have adopted the single regulator model to provide
better supervision of their domestic financial markets as well as part of the effort called
for by the Lamfalussy report to stimulate further financial integration at the EU level by
converging national regulatory structures. On the other hand, many CEECs have decided
that a specialized securities regulator is better at promoting the kind of investor
confidence that their emerging securities markets need in order to grow. As a result of
this gap between what is optimal for securities regulation from the EU’s perspective and
what will stimulate growth in the CEECs’ securities markets, the Commission could not
pursue the dual tasks of integration and development simultaneously. Forced to choose
between the two, the Commission appears to have adopted a standard of review that has
permitted the CEECs to put the interests of securities market development above those of
regional integration.
Another important factor in the Commission’s decision to allow the CEECs to adopt a path for regulatory development that may be at odds with EU integration is the timing of the accession process in relation to the Lamfalussy report. As noted earlier, it was not until 2001 that the Lamfalussy committee published its final report, in which it identified variances among national regulatory structures as a major impediment to the creation of an internal market for securities at the EU level. By the time the Lamfalussy report was finally made public, the enlargement round for the CEECs had already been going on for approximately four years. During that early period, the Commission did not identify the consolidation of financial supervision as a priority for the accession process.

In its 2001 report on the Czech Republic, however, the Commission mentions for the first (and only) time that a single financial regulator would be preferable to the current system of regulatory fragmentation in the Czech Republic for supervising the growing number of financial conglomerates. It is probably no coincidence that the Commission first suggested consolidated financial supervision as a possibility for the Czech Republic at roughly the same time as the Lamfalussy report recommended greater regulatory convergence among member states. Nevertheless, by 2003 the Commission was no longer insisting on consolidated financial supervision and instead accepted a trilateral agreement among Czech financial regulators to reinforce cooperation among the agencies as a substitute for a more radical reorganization of financial supervision.


The Commission’s reversal of its position here on consolidated supervision most likely represents a recognition of the fact that at this late stage in the accession process – after the Commission had overseen the establishment of a specialized securities regulator in the Czech Republic – it is difficult to force the CEECs to change their course of regulatory development to conform to the recommendation put forth by the Lamfalussy Committee. It seems likely, however, that the Commission would have taken a more aggressive stance with respect to the structure of financial regulation in the CEECs if the concerns expressed by the Lamfalussy report over variance among national regulators had come to light prior to the accession process.

In sum, an analysis of Hungary’s experience with consolidated financial supervision reveals how the disparity between the level of securities market development in the CEECs and current EU member states as well as the timing of the Lamfalussy report contributed to the decision by the Commission to adopt a permissive approach towards the structure of financial regulation in the candidate countries. Such an approach, in turn, has allowed many CEECs to pursue developmental goals at the possible expense of regional integration in designing the institutions responsible for overseeing their financial markets.
Conclusion

As suggested by the analysis above of securities regulation in the Czech Republic and Hungary, the processes of EU integration and securities market development have converged during this current round of enlargement on the need for stronger systems of financial supervision in the CEECs. Perhaps the best example of this convergence is the key role that oversight by the Commission played in the establishment of an independent securities commission in the Czech Republic and in the subsequent improvements to Czech securities regulation during the accession period. Where the processes of EU integration and securities market development have diverged, however, is in the institutional design for the financial regulators to be strengthened during enlargement. While the Lamfalussy Committee has called for a convergence of national regulatory structures and the vast majority of current EU member states have adopted a consolidated approach to financial supervision, the CEECs with the largest equity markets have kept – with the exception of Hungary – their specialized securities regulators based on the belief that this regulatory design is better for their emerging securities markets.

From this evidence on securities regulation in the CEECs during accession, one can extrapolate a somewhat tentative rule for the inter-relationship between EU integration and capital market development. The analysis of securities regulation in the Czech Republic and Hungary suggests that the higher the level of generality for a particular rule or requirement, the more likely that the processes of integration and capital market development will coincide. For instance, the paper has shown how the establishment of stronger financial regulators in the CEECs has served the interests of both EU integration and securities market development in the candidate countries.
Conversely, the more specific a particular rule or requirement is, the more likely that there will be conflict between what is best for the EU and what is best for the emerging financial markets in the CEECs. The main example here is that while the EU and the CEECs could find common ground on the need for stronger financial regulators, their respective interests seem to have diverged with regard to the optimal design for those financial regulators.

Although this paper has only examined the inter-relationship between securities regulation and EU integration in the context of accession, one can expect that the difference observed above between general and more specific rules will have important ramifications in the future as the EU attempts to absorb the CEECs into its internal capital market and create a regulatory zone for securities that can account for even wider variations in financial market development among its member states.
## Appendix A

### Equity Market Capitalization of Major Stock Exchanges in Europe (February 2004)

<table>
<thead>
<tr>
<th>Exchange</th>
<th>Value (EUROm) at Month End</th>
<th>% change on previous year end (EURO)</th>
<th>% change on previous year end (loc. curr.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Athens Exchange</td>
<td>90 180.97</td>
<td>6.7</td>
<td>6.7</td>
</tr>
<tr>
<td>Bratislava Exchange</td>
<td>2 197.56</td>
<td>- 0.3</td>
<td>- 1.8</td>
</tr>
<tr>
<td>Budapest Exchange</td>
<td>14 343.07</td>
<td>8.4</td>
<td>6.6</td>
</tr>
<tr>
<td>Copenhagen Exchange</td>
<td>106 341.30</td>
<td>13.5</td>
<td>13.6</td>
</tr>
<tr>
<td>Cyprus Exchange</td>
<td>4 220.00</td>
<td>10.8</td>
<td>10.7</td>
</tr>
<tr>
<td>Deutsche Börse</td>
<td>864 097.00</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Euronext</td>
<td>1 721 912.00</td>
<td>4.6</td>
<td>4.6</td>
</tr>
<tr>
<td>Helsinki Exchanges</td>
<td>157 068.60</td>
<td>16.3</td>
<td>16.3</td>
</tr>
<tr>
<td>Iceland Exchange</td>
<td>9 237.32</td>
<td>25.5</td>
<td>21.0</td>
</tr>
<tr>
<td>Irish Stock Exchange</td>
<td>68 385.73</td>
<td>1.4</td>
<td>1.4</td>
</tr>
<tr>
<td>Italian Exchange</td>
<td>507 942.40</td>
<td>4.2</td>
<td>4.2</td>
</tr>
<tr>
<td>Lithuanian Exchange</td>
<td>3 293.90</td>
<td>18.4</td>
<td>18.4</td>
</tr>
<tr>
<td>Ljubljana Exchange</td>
<td>6 108.74</td>
<td>7.9</td>
<td>8.3</td>
</tr>
<tr>
<td>London Exchange</td>
<td>2 061 904.00</td>
<td>7.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Luxem. Exchange</td>
<td>31 565.72</td>
<td>6.6</td>
<td>6.6</td>
</tr>
<tr>
<td>Malta Stock Exchange</td>
<td>1 691.29</td>
<td>15.3</td>
<td>16.5</td>
</tr>
<tr>
<td>Oslo Börse</td>
<td>84 465.40</td>
<td>11.5</td>
<td>15.6</td>
</tr>
<tr>
<td>Prague Exchange</td>
<td>16 092.52</td>
<td>31.0</td>
<td>31.1</td>
</tr>
<tr>
<td>Spanish Exchanges</td>
<td>608 899.10</td>
<td>5.8</td>
<td>5.8</td>
</tr>
<tr>
<td>Stockholmsbörsen</td>
<td>247 031.30</td>
<td>7.7</td>
<td>8.0</td>
</tr>
<tr>
<td>SWX Swiss Exchange</td>
<td>598 367.50</td>
<td>3.8</td>
<td>5.2</td>
</tr>
<tr>
<td>Virt-X</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Warsaw Exchange</td>
<td>31 737.90</td>
<td>8.1</td>
<td>11.7</td>
</tr>
<tr>
<td>Wiener Börse</td>
<td>50 356.00</td>
<td>12.4</td>
<td>12.4</td>
</tr>
</tbody>
</table>

Source: Federation of European Securities Exchanges
(http://www.fese.org/statistics/index.php)
Appendix B

Summary of Recommendations by Commission and Response from Czech Officials

<table>
<thead>
<tr>
<th>Problem Cited by Commission in July 1997 Opinion and Annual Reports</th>
<th>Remedial Action Taken by Czech Officials</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of independent securities regulator</td>
<td>Established Czech Securities Commission</td>
</tr>
<tr>
<td>Illiquidity in secondary trading markets</td>
<td>Delisting of shares from Prague Stock Exchange and RM-System</td>
</tr>
<tr>
<td></td>
<td>“SPAD” trading module introduced on Prague Stock Exchange</td>
</tr>
<tr>
<td>Non-transparency of securities markets</td>
<td>Relicensing of brokers</td>
</tr>
<tr>
<td></td>
<td>Higher listing standards on Prague Stock Exchange</td>
</tr>
<tr>
<td>Market fragmentation</td>
<td>RM-System regulated as stock exchange</td>
</tr>
<tr>
<td></td>
<td>Members of Prague Stock Exchange required to report all off-exchange trades</td>
</tr>
<tr>
<td>Bifurcated regulatory structure between Ministry of Finance and Czech Securities Commission</td>
<td>Power to issue binding regulations given to Czech Securities Commission</td>
</tr>
<tr>
<td>Financial dependence of Czech Securities Commission on state budget</td>
<td>No remedial action taken</td>
</tr>
</tbody>
</table>
Appendix C

Comparison of the Relative Sizes of the Economies in the Scandinavian Countries, Hungary and the Czech Republic

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>5.4</td>
<td>172.4</td>
<td>106,341</td>
</tr>
<tr>
<td>Norway</td>
<td>4.5</td>
<td>190.6</td>
<td>84,456</td>
</tr>
<tr>
<td>Sweden</td>
<td>8.9</td>
<td>240.9</td>
<td>247,031</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>10.2</td>
<td>69.5</td>
<td>16,092</td>
</tr>
<tr>
<td>Hungary</td>
<td>10.1</td>
<td>65.8</td>
<td>14,343</td>
</tr>
</tbody>
</table>

Sources: Economist Intelligence Unit (http://www.economist.com/countries/); Federation of European Securities Exchanges