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Gus Van Harten

Editorial[†]

Many people ask me: how does it feel to be the Editor-in-Chief of one of the first European student-run law journals? I still have not found a unique answer to such a question. Perhaps, a unique answer does not even exist. The truth is that, like any noteworthy adventure, it involves a great variety of concomitant yet winking feelings and sensations. The excitement for the unexpected is often mixed with the fear of what is coming next and cannot be foreseen, while the need for self- improvement often gives way to an air of resignation, to be turned on again in extreme positivity. For me, being the founder and Editor-in-Chief of the University of Bologna Law Review has represented – and still represents – one of the most significant events of my life. I can say that for sure.

This has all started from a simple idea coming up during a cold winter evening - I know, it seems like I am quoting a thriller, but that is the gospel truth: such simple idea has been developed through chilly days, then warm ones, then chilly and then cold ones again, giving birth to an incredible full-optional car you really cannot stop driving. The core of the journal is composed of its scientific committee and editorial team, including more than thirty students from the University of Bologna, School of Law, and several Visiting Editors, i.e. foreign students and recent graduates willing to live an editorial experience with us. We feel like a big family, in which we have shared – and keep sharing – dreams, hopes, ideas, passions and studies.

The University of Bologna, through the Department of Legal Studies, has allowed us to achieve something extraordinary, which pushes the students into performing a complex set of activities since their first year of law school. Our editors, therefore, learn how to analyze manuscripts, to carry out editing activities following The Bluebook sections of their competence, to work in a team as well as independently and, maybe the most important, to deeply respect their teammates. It is amazing to see what students are able to do if sufficiently encouraged, and the incredible energy they can share. I often think about the changes that the University of Bologna Law Review has

lived through and it makes me smile. Yes, I smile because I am pleased to have shown to many people the students' value, often set aside in a tedious learning routine.

The University of Bologna has decided to believe in its students and to rejoice with us in our results. There is only one last doubt standing, which will never see an answer: who knows how I would have come off, if the law journal had already existed while I was a student, and, above all, would I have got through the admission process?

October, 2016

Antonio Alderuccio, JD

[†] My deep and sincere gratitude goes out to the whole Department of Legal Studies of the University of Bologna, with special thanks to Professor Antonino Rotolo, Professor Michele Caianiello, Professor Giovanni Luchetti and Professor Nicoletta Sarti, Cleary Gottlieb Steen & Hamilton LLP, with special thanks to Esq. Giuseppe Scassellati-Sforzolini, and generally all those who have steadily supported our project. Finally, a mention of acknowledgment towards Alma Digital Library and Dott. Paolo Turrini is due.

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Form and Function in Doing Business Rankings: is Investor Protection in Italy Still so Bad?

LUCA ENRIQUES & MATTEO GARGANTINI[†]

TABLE OF CONTENTS: 1. Introduction; 2. The Doing Business Report and the Measurement of Investor Protection; 3. The DBR: Impact on National Reform Agendas and Criticisms; 4. The Italian Framework on Related Party Transactions; 5. Measuring Investor Protection in Italy After the Regulation on Related Party Transactions; 6. The DBR Evaluation. Methodological Issues; 7. The Impact of Miscoding; 8. Conclusions: Functional Approach and Transparent Assessment.

ABSTRACT: Every year the World Bank's Doing Business Report (DBR) ranks numerous jurisdictions across the globe according to their ability to facilitate business activities. Among the indexes which contribute to the definition of the global competitiveness of legislations, the "Protecting investors index" (PII) measures the protection of minority shareholders in listed companies. In this paper, we analyse the DBR's assessment of the Italian regulatory framework on investor protection. We find that the PII fails to properly evaluate the applicable rules. First, it underrates Italy because the DBR evaluation misinterprets the role performed by independent directors under Italian rules on related party transactions. In particular, the DBR fails to properly account for the powers of independent directors to veto unfair transactions before they are submitted to the board. This measure ensures that minority investors are assured a level of protection which is at least equivalent to the mandatory abstention by conflicting directors. Second, as past DBR overrated the PII subsequent reforms which have substantially improved investor protection have not been accounted for by more recent assessments, which give the misleading impression that no relevant changes have occurred. Far from representing one of the multiple coding errors reported in the literature, these flaws aptly show that the DBR methodology, while correctly attempting to preserve consistency in the evaluation of different jurisdictions, adopts an excessively formalistic approach and disregards the function of the rules it scrutinizes. In light of the influence that the DBR exerts on national policymakers, this approach is detrimental because it might induce window-dressing reforms. Moreover, it may rule out experimentation, which is a key element in ensuring that the applicable rules keep pace with the variety of techniques which are adopted to expropriate minority shareholders.

KEYWORDS: *Doing Business Report; Investor Protection; Related Party Transactions; Law and Finance; Comparative Corporate Governance.*

This paper is due to appear in the Studies in Honour of Diego Corapi. The authors were, respectively, a Consob Commissioner and his aide between 2007 and 2012. They also took part to a Bank of Italy seminar in which the issues discussed in this paper were addressed with the DBR team. Although the essay is the result of a joint effort, parts 1, 2, 3, 5, 6, and 7 are to be attributed to Matteo Gargantin

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1. INTRODUCTION

The Doing Business Report [hereinafter DBR] is an assessment exercise prepared by the World Bank with the aim of comparing the efficiency of nearly two hundred jurisdictions. On a yearly basis, the DBR assesses national regulatory frameworks against benchmarks covering various fields of business law; the results of the evaluation are reported in a ranking of all concerned jurisdictions. The DBR exerts significant influence on the assessed nations. If the rankings display unsatisfying results, political pressure in the concerned countries often induces governments to put the inefficiencies highlighted by the exercise high on the reform agenda.

One of the areas the DBR covers is investor protection: the "Protecting investors index" [hereinafter PII] aggregates scores calculated for a number of variables, which code the presence (or absence) of rules increasing shareholder protection according to the DBR methodology. More precisely, the PII measures how jurisdictions protect minority shareholders in listed companies with regard to a hypothetical transaction between a listed company and its controlling shareholder.

The DBR methodology on investor protection has triggered a lively academic debate on both theoretical and practical aspects. On the one hand, the adequacy of criteria and even the possibility to measure the efficiency of legislations have been called into question. On the other hand, coding mistakes have been reported for various jurisdictions. We do not enter here the discussion on the merits of benchmarking economic legislation across jurisdictions which belong to different legal traditions,[1] nor we scrutinize the appropriateness of the variables the PII relies upon. Rather we purport to criticize the DBR assessment of investor protection in Italy as the outcome of exceedingly formalistic evaluations. We also show that previous misunderstandings of the relevant laws have led to underestimate more

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[1] Similar benchmarking exercises are performed in the European Union, especially in the field of labour and social law, under the so-called "Open Method of Coordination": *see, e.g.*, Sabrina Regent, *The Open Method of Coordination: A New Supranational Form of Governance?*, 9 EUR. L. J. 190 (2003).

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recent progresses of the Italian legislation, so that the historical performances reported in the DBR with a view to showing the evolution of the legal framework give the false impression that no advancement was made over the last years.

Although we concentrate on coding mistakes, our analysis has broader implications. Our key argument is that in both the design and the measurement of the variables composing the evaluation grid a functional approach should be preferred over a formalistic analysis.[2] When the relevant legal regime ensures the same result the DBR envisages, although via a different legal device, then the assigned score should reflect the equivalent level of investor protection. This may require greater flexibility in the definition of variables. Further, we stress that, when assessing the rules which apply to investor protection in a given jurisdiction, attention should be paid to the broader national legal framework. Effective investor protection may, indeed, be better ensured by rules that, despite not matching the relevant criterion at first sight, could lead to a different assessment if considered as part of a broader legal context rather than in isolation.[3]

After describing the DBR methodology (part 2), the paper summarizes the ongoing academic debate on the positive and negative aspects of the DBR assessments (part 3). The main provisions of the Italian framework on related party transactions [hereinafter RPTs] are then illustrated (part 4). It is then shown how the DBR evaluation fails to consider that this framework ensures results equivalent to those provided for by the DBR criteria by utilising different regulatory tools (part 5). We then analyse more in depth

[2] *See* John Armour et al, *How Do Legal Rules Evolve? Evidence from a Cross-Country Comparison of Shareholder, Creditor, and Worker Protection*, 57 AM. J. COMP. L. 586, 600 (2009) (claiming that variables should be selected according their functional impact on corporate practices and proposing a set of criteria aimed to match functional variables with formal rules). *See also* Mathias Siems & Simon Deakin, *Comparative Law and Finance: Past, Present and Future Research*, 166 JITE 124 (2010) (comparative law is functionalist, while comparative law and finance typically just verifies if one specific legal rule does or does not exist in different countries); Mathias Siems, *Numerical Comparative Law: Do We Need Statistical Evidence in Law in Order to Reduce Complexity?*, 13 CARDOZO J. INT'L & COMP. L. 531, 540 (2005) (while statistical evaluations typically confine themselves to verifying whether a legal provision exists in a jurisdiction, indices should include measures that contain functional equivalents in order to avoid distorted outcomes).

[3] *See generally* Benito Arruñada, *How Doing Business Jeopardises Institutional Reform*, 10 EUR. BUS. ORG. L. REV. 571 (2009) (noting that "measuring institutions in countries with different legal traditions requires appreciating that different legal structures suit different contexts"). *See also* Armour et al., *supra* note 2, at 596 (a particular institution, even if suboptimal in isolation, should be retained when its removal would exert adverse effects on other complementary institutions).

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the methodological flaws underlying this miscoding so as to demonstrate how a functional approach would help obtain a more accurate assessment (part 6). The impact of the miscoding is then quantified in order to show how the DBR's inaccuracies may create perverse incentives by reducing countries' willingness to enact effective legislation whilst inducing window-dressing reforms (part 7). Part 8 concludes.

2. THE DOING BUSINESS REPORT AND THE MEASUREMENT OF INVESTOR PROTECTION

Since 2004, the International Finance Corporation – a member of the World Bank Group – has been assessing the quality of economic legislations across the globe. The study compares the relative ease of running a business activity in each jurisdiction. Its results are published on a yearly basis in the DBR, which shows how assessed countries are performing under the common criteria so as to highlight improvements in their respective regulatory frameworks.

The DBR results are reported in a single global index ("Ease of doing business") and in sectorial rankings which address specific aspects of business activities. Among these partial rankings, the "Protecting investors index" (PII) was first introduced in 2005 in order to assess how effectively minority shareholders' interests are protected against expropriation via conflict-of-interest transactions. The underlying rationale is that economic development prospers where property rights (in this case, investors' entitlements) are clearly defined ex ante and effectively enforced ex post.[4]

[4] *See* Claude Ménard & Bertrand Du Marais, *Can We Rank Legal Systems According to Their Economic Efficiency?*, 26 J.L & POL'Y 61 (2008) (recalling Hernando de Soto's theory on reduction of informality – and consequently of transaction costs – through definition and implementation of property rights). On the theoretical framework underlying the DBR see Beth Ahlering & Simon Deakin, *Labor Regulation, Corporate Governance, and Legal Origin: A Case of Institutional Complementarity?*, 41 LAW & SOC'Y REV. 865, 869-872 (2007); BERTRAND DU MARAIS, DES INDICATEURS POUR MESURER LE DROIT?: LES LIMITES MÉTHODOLOGIQUES DES RAPPORTS DOING BUSINESS 21-23 (Bertrand Du Marais ed., 2006); Alessio M. Pacces, *How does Corporate Law Matter? 'Law and Finance' and Beyond*, in MICHAEL FAURE & SMITS, DOES LAW MATTER? ON LAW AND ECONOMIC GROWTH 297, 299-300 (Michael Faure & Jan Smits eds., 2011).

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The assumption is hardly questionable,[5] although causation[6] (and even correlation[7]) between the quality of legislation in force and the development of financial markets is still an open issue.

In order to assess the protection against directors' misuse of corporate assets, the PII aggregates data on the relevant legislation according to a standardised set of criteria.[8] Relevant provisions in every jurisdiction are evaluated and scored according to three sub-indexes which respectively measure disclosure required for RPTs ("Extent of disclosure" index), directors' liability ("Extent of director liability" index), as well as the availability of legal remedies to shareholders ("Ease of shareholder suit" index). The PII is the average of the three sub-indexes.

Variables register, inter alia, what corporate body is entitled to approve the transaction, how detailed and extensive is the information available to such body before it decides and subsequently provided to the public at large. Enforcement-related features are also taken into account (e.g. the possibility for shareholders which represent less than 10% of the

[5] *See* INDEP. EVALUATION GRP., *An Independent Evaluation Taking the Measure of the World Bank-IFC Doing Business Indicators*, 3 (Oct., 2008).

[6] John Coffee, *The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control*, 111 YALE L. J. 1, at 59-66 (2011) (in many instances, stock market developed before legislation aimed at protecting minority shareholders was introduced); BRIAN R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED 35-40 (2010) (U.K. law traditionally offered scant protection to investors, in spite of financial market development).

[7] *See also* John Armour et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origin Hypothesis*, 6 J. EMPIRICAL LEGAL STUD. 343 (2009).

[8] Since its first publication in September 2003, the DBR has rested upon methodologies inspired by the well-known scientific studies by Andrei Shleifer and his co-authors. *See initially* Int'l Fin. Corp. [IFC], *Doing Business in 2004. Understanding Regulation*, DOINGBUSINESS.ORG, 7 (Sep., 2003),http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB04-FullReport.pdf. For PII see Int'l Fin. Corp. [IFC], *Doing Business in 2005. Removing obstacles to growth*, DOINGBUSINESS.ORG, 85 (Jan. 1, 2005), http://www.doingbusiness.org/~/media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB05-FullReport.pdf, referring to Rafael La Porta et al., *Law and Finance,* 106 J. POL. ECON. 1113 (1998) where a first set of criteria – "anti-director rights index" – was proposed with a view to testing possible correlations between the quality of company and securities law, on the one hand, and ownership concentration in listed companies, on the other hand; *id.* at 1150. *See subsequently* Int'l Fin. Corp. [IFC], *Doing Business 2010. Reforming through difficult times*, DOINGBUSINESS.ORG,42(Sep.9,2009),http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB10-FullReport.pdf, where reference is made to Simeon Djankov et al., *The law and economics of self-dealing*, 88 J. FIN. ECON. 430 (2008) (defining a new and more detailed grid – "self-dealing index"). For further details on similar studies underpinning other indices within the DBR see Kevin E. Davis & Michael B. Kruse, *Taking the Measure of Law: The Case of the Doing Business Project*, 32 LAW & SOC. INQUIRY 1101 (2007). Reliance on academics or outsources in the production of indicators is no exception: *cf.* Kevin E. Davis et al., *Introduction: Global Governance by Indicators in* GOVERNANCE BY INDICATORS. GLOBAL POWER THROUGH QUANTIFICATION AND RANKINGS 3, 13 (Kevin E. Davis et al. eds., 2012).

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outstanding capital to directly or derivatively initiate a claim, as well as directors' liability for damages and the availability of disgorgement of profits). Access to evidence through discovery is also a criterion of assessment.

Variables are measured against a hypothetical transaction which is identical for all jurisdictions. The fictional company – "Buyer," a manufacturing firm listed on the most important stock exchange of the concerned country – purchases a truck fleet from another company ("Seller"). Mr James, holding a 60% stake of the outstanding capital, is Buyer's controlling shareholder and also a member of the board of directors. He also owns the 90% of Seller. In the transaction, which falls within the scope of Buyer's ordinary course of business, the fleet value equals 10% of Buyer's assets and its price is set above the market value. It is also assumed that all the "required approvals" for the transaction are obtained and that disclosure is made, so that no fraud has occurred. In this scenario, Buyer incurs into a loss and its shareholders decide to sue Mr James, along with those who are involved in the transaction.

The evaluation team first establishes what rules apply to the relevant transaction in the various jurisdictions. Depending on the availability of the legal remedies, scores are then assigned by reflecting the assumption that the higher the number of regulatory tools for protecting against tunneling, the stronger the protection for investors.

3. THE DBR: IMPACT ON NATIONAL REFORM AGENDAS AND CRITICISM

In line with the declared purpose of stimulating reforms - on the assumption that an efficient regulatory environment is pivotal in fostering economic growth – the influence of the DBR on national policy debates is remarkable.[9]

[9] *See* INDEP. EVALUATION GRP., *supra* note 5, at 44-6 (DBR fosters national debates on legislative reforms, although its role as a guide for policy priority is weak because it often focuses only on specialized aspects of larger problems and disregards national contexts). *See also* INDEP. PANEL, *Review of the Doing Business Report*, DBRPANEL.ORG, 19 (Jun. 24, 2013), http://faculty.washington.edu/hgwolff/Doing%20business%20review%20panel%20report%20with%20signatures%20and%20Bibliography.pdf, many institutions refer to the DBR without considering its inherent limitations. *See also* Ralf Michaels, *Comparative Law by Numbers? Legal Origins Thesis, Doing Business Reports, and the Silence of Traditional Comparative Law*, 57 AM. J. COMP. L. 772 (2009) (listing the factors making the DBR appealing and assessing DBR's impact).

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On the one hand, some countries have passed legal reforms with the explicit purpose of matching the criteria set by the DBR's evaluation grid.[10] On the other hand, academics and politicians from other jurisdictions have harshly opposed the assessment method and its results. Widespread criticism also testify to the significance of the DBR.[11]

The reasons for such significance are manifold. For developing countries, the possibility to access the lending programs of the World Bank may depend on the results of the DBR evaluation, which is regarded as a proxy of the aided country's willingness to improve its economic performance to the advantage of citizens' living standards. For developed economies, unsatisfactory rankings exert political pressure on governments. Their "name and shame" effect is often amplified by the extensive press coverage on the DBR.[12] The DBR, as opposed to other evaluation studies on national performances,[13] displays the results of benchmarking by ranking all participating jurisdictions on the basis of their performance. This creates a feeling of competition among jurisdictions.[14] These rankings satisfy the need for easy-to-use information[15] because they exert great symbolic power and, regardless of the technicalities that characterise local legislation, are easy to understand for the public at large.[16]

[10] *See, e.g.*, Caralee McLiesh & Pedro Arizti, *The Doing Business Project,* in OECD, MFDR PRINCIPLES IN ACTION: SOURCEBOOK ON EMERGING GOOD PRACTICES 110 (2006) (reporting how Jordan, Korea, Mozambique, Nicaragua, Serbia and Montenegro have used the DBR as a reform driver).

[11] For France see DU MARAIS, *supra* note 4.

[12] *See* INDEP. EVALUATION GRP., *supra* note 5, at 41 (communication strategy is one of the determinants of DBR's success but may sometimes mislead users, for example with regard to assertions of causations when only correlation is demonstrated).

[13] *See, e.g.*, CEPEJ, *European Judicial Systems. Efficiency and Quality of Justice*, COE.INT (2012), http://www.coe.int/t/dghl/cooperation/cepej/evaluation/2014/Rapport_2014_en.pdf (on the evaluation of domestic judicial systems).

[14] Rankings, as opposed to ratings, may give the impression that no reform is made to the extent that numerous jurisdictions are improving at the same time, and may hide the degree of variation between countries (David Irwin, *Doing Business: Using Ratings to Drive Reform*, 26 J. INT'L. DEV., 658 (2013) (ebook). *See also* INDEP. EVALUATION GRP., *supra* note 5, at xvi ("changes in a country's ranking depend importantly on where it sits on the distribution; small changes can produce large ranking jumps, and vice versa. These factors contribute to anomalies in rankings"); INDEP. PANEL, *supra* note 9, at 2, 20-2 (which, while suggesting maintenance of country rankings, admits that cardinal scores – already provided by the DBR with the "Distance to Frontier" metrics – are more informative; for subsequent developments see *infra* note 18 and text accompanying note 29).

[15] *See* Siems, *supra* note 2, at 534 (numerical analysis satisfies the need to reduce complexity in order to increase the practical role of comparative law).

[16] *See* Ralf Michaels, *The Functionalism of Legal Origins*, in DOES LAW MATTER? ON LAW AND ECONOMIC GROWTH 31 (Michael Faure & Jan Smits eds. 2011) (reductionist quality of rankings is an advantage for their marketability).

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While DBR's influence has been significant since its first publication,[17] a number of legal academics have harshly questioned its methodology and results. Criticisms have addressed two key aspects of the evaluation process. The selection of the standards according to which the ease of carrying out an economic activity should be assessed, along with the process for evaluating compliance with those standards have both been contested. Remarks concerning the selection of standards often address the very possibility of measuring the legislation applicable in different jurisdictions against a single yardstick, thus avowedly[18] following a "one-size-fits-all" approach.[19] Critics argue that the preferable approach varies according to the legal, political, and social context.[20] First, interaction with rules left outside the scope of the assessment may limit, and perhaps even revert, the positive effects of rules that the DBR methodology considers in isolation. Second, good law on the books does not mean good law in action, the latter depending on formal and informal enforcement mechanisms. However, the DBR notoriously disregards enforcement practices.[21]

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[17] The Doing Business indicators are frequently mentioned among the most important indexing exercises: *see, e.g.*, DAVIS et al., *supra* note 8, at 3.

[18] Int'l Fin. Corp. [IFC], *supra* note 8, at xvi; INDEP. PANEL, *supra* note 9, at 23; *see also* as regards labour law *id.* at 3, 28 highlighting a switch towards a more nuanced approach on the "employing workers" measurement, for which the DBR has recently provided absolute data instead of rankings. Some amendments to the DBR methodology announced in April 2014 will change the approach currently followed for the remaining indexes as well. In particular, the DBR will emphasize variations in the distance between the results achieved by each country, on the one hand, and the performance of the most efficient jurisdiction, on the other hand. This should help point out more clearly improvements that, while changing the distance between competitors, are not sufficient to ensure a better ranking. *See* Int'l Fin. Corp. [IFC], *Forthcoming changes to the Doing Business report*, DOINGBUSINESS.ORG (Apr. 30, 2014),http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Methodology/Survey-Instruments/DB15/Forthcoming-methodology-changes-to-the-Doing-Business-Report.pdf.

[19] For a review *see* Pacces, *supra* note 4, at 303-307.

[20] Davis & Kruse, *supra* note 8, at 1102-1103. Benito Arruñada, *Pitfalls to avoid when measuring institutions: Is Doing Business damaging business?,* 35 J. COMP. ECON. 734 (2007); Ménard & Du Marais, *supra* note 4, at 77-80; INDEP. PANEL, *supra* note 9, at 3.

[21] *See* INDEP. EVALUATION GRP., *supra* note 5, at xv-xvi and xxiv (DB indicators primarily measure laws and regulations as they are written, but the relevance of each indicator depends on actual implementation of the law, which DB does not aim to measure).

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Further, regardless of how well the variables have been construed, some degree of subjectivity in weighing the importance of each criterion and, therefore, in determining the final rankings is unavoidable.[22]

Doubts are also cast on the ability of one or more specific criteria to properly measure the legal environment where entrepreneurs operate. The World Bank itself has recognised that the policy implications of its evaluation might be questionable, and has subsequently amended its methodology. For instance, the original labour law indicator which measures the ease of hiring and firing workers has raised widespread concerns. The indicator rested on the assumption that less regulation, and therefore fewer burdens on employee dismissal should be regarded as a proxy for higher efficiency. Critics stressed that deregulation does not necessarily mean better regulation.[23] They argue that there is no evidence that light-touch labour law improves economic performance or creates more jobs.[24] Such remarks led to an amendment of the methodology for labour law, now included in the new "employing workers" indicator, and to its exclusion from the indexes composing the "Ease of doing business".[25]

Other criticisms have addressed the "Ease of starting a business"[26] and the PII itself. As a consequence, they have called into question the global "Ease of doing business" indicator which inevitably reflects, or even amplifies, improper definitions of sub-indexes.[27]

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[22] *Cf.* For a similar consideration with reference to corporate governance indices see Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices,* 108 COLUM. L. REV. 1825 (2008) (market participants may have divergent preferences when weighting governance features, and some variables may be substitutes for others).

[23] *See* DAVIS et al., *supra* note 8, at 9 (Every selection of variables inevitably reflects underlying ideological assumptions on the role of regulation and its effects on society).

[24] *See, e.g.*, Janine Berg & Sandrine Cazes, *Policymaking Gone Awry: The Labor Market Regulations of the Doing Business Indicators,* 29 COMP. LAB. L. & POL'Y J. 350, 355-360 (2008).

[25] *See* Peter Bakvis, *The World Bank's Doing Business Report: A last fling for the Washington Consensus,* 15 EUR. REV. LAB. RES 434 (2009); Int'l Fin. Corp. [IFC], *Doing Business 2014. Understanding Regulations for Small and Medium-Size Enterprises*, DOINGBUSINESS.ORG, 2 (Jun. 1, 2013),http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB14-Full-Report.pdf.

[26] *See* Arruñada, *supra* note 20, (DBR methodology, which assigns a better score to jurisdictions where procedural requirements such as preregistration and registration are cheaper and less time-consuming, underestimates the costs of reduced legal certainty); for a reply *contra* Simeon Djankov et al., *The law and economics of self-dealing*, 88 J. FIN. ECON. 430 (2008). *See also* Arruñada, *supra* note 3, for a counter-reply.

[27] *See* INDEP. PANEL, *supra* note 9, at 4 (noting that there is no strong justification for simple averaging across indicators to produce the Ease of doing business index and suggesting its removal).

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Some scholars have proposed alternative assessment criteria for shareholder protection in the attempt to have a more accurate understanding of the comparative advantages of different jurisdictions.[28] Further changes in the DBR methodology, which have been announced in April 2014, will tackle some of these critiques in an attempt to improve the completeness of the evaluation. This would lead to a more careful consideration of its results.[29] The evaluation grid will inevitably remain exposed to critiques. Scholars would still have diverging opinions on the relative importance of the diverging legal rules.

Regardless of the theoretical debate, the accuracy of DBR assessments has also been challenged.[30] The exercise relies on imaginary transactions – such as the one involving Buyer and Seller, sketched in Part 2 – that are devised to test how the law would operate in similar circumstances.[31] Data on the applicable rules are gathered by submitting questionnaires to local experts. Results are subsequently discussed with the World Bank team in charge of the evaluation.[32]

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[28] For an alternative shareholder protection index cf. Priya P. Lele & Mathias M. Siems, *Shareholder Protection: A Leximetric Approach,* 7 J. CORP. L. STUD. 17 (2007). On the same index see also Siems & Deakin, *supra* note 2, at 128-135. CENTRE FOR BUSINESS RESEARCH, EXTENDED SHAREHOLDER PROTECTION INDEX (www.cbr.cam.ac.uk).

[29] The PII will be renamed "protecting minority investors" index and will cover an extended set of rules. For instance, attention will be paid to shareholders rights, including pre-emption on newly-issued shares and the presence of a mandatory bid rule, as well as to rules concerning decisions that have to be submitted to the general meeting, such as issuance of new shares. Furthermore, the assessment will address the composition of the board of directors as regards the presence of non-executive or independent members and the separation of the chairperson and the CEO; *see* Int'l Fin. Corp. [IFC], *supra* note 8, at 3. *See also* Int'l Fin. Corp. [IFC], *Doing Business 2015. Measuring Business Regulation – Questionnaire*, DOINGBUSINESS.ORG (2015), http://www.doingbusiness.org.

[30] *See, e.g.*, Davis & Kruse, *supra* note 8, at 1104-1107, 1111-1115 (concluding that shortcomings in the DBR assessments make the report too unsound to be used as the basis for across-the-board legal reforms).

[31] This approach has also been criticized by some scholars, in whose opinion the selection of a hypothetical scenario by economists from the United States is very likely to reflect the specific characteristics of common law jurisdictions, thus biasing the subsequent comparison with civil law jurisdictions (*see* Michaels, *supra* note 9, at 786). *See also* Siems & Deakin, *supra* note 2 (as the Law and Finance stream of research is mainly based on U.S. securities law, it can be regarded as a "hidden benchmarking" which measures the vicinity to the U.S. model); INDEP. PANEL, *supra* note 9, at 16 (the selection of the hypothetical scenarios used to test the variables may be prone to home biases). DBR criteria's appropriateness was however questioned from a U.S. perspective as well (Pacces, *supra* note 4, at 303).

[32] For a description see INDEP. EVALUATION GRP., *supra* note 5, at 13-9; Davis & Kruse, *supra* note 8, at 1095, 1099-1100.

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That procedure has not always been reliable.[33] For instance, Italy's PII score has also been affected by mistakes which were later admitted by the DBR itself.[34]

4. THE ITALIAN FRAMEWORK ON RELATED PARTY TRANSACTIONS

The Regulation on Related Party Transactions [hereinafter, "the RPT Regulation" or "the Regulation"] sets out the rules and principles that Italian listed companies have to respect in order to ensure that RPTs are adequately disclosed to the market and fulfil minimum standards of substantial and procedural fairness.[35] The Regulation was approved by Consob – the Italian Securities and Exchange Commission – in 2010 and fully enacted one year later. The Regulation contains a set of detailed rules while

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[33] Numerous mistakes afflicting the first DBR on France were pointed out in the fracas raised by the French legal and political community (*see also* DU MARAIS, *supra* note 4, at 45: binary codes do not fit with instances where more than two options are available under national law) and were therefore fixed in the subsequent editions (Anne-Julie Kerhuel & Bénédicte Fauvarque-Cosson, *Is Law an Economic Contest? French Reactions to the Doing Business World Bank Reports and Economic Analysis of the Law,* 57 AM. J. COMP. L. 811, 815-816 (2009). Mistakes affecting other countries in the measurement of the "Ease of starting a business" index are reported by Arruñada, *supra* note 20, at 743-744, and Arruñada, *supra* note 3, at 559. *See also* Bjørn Høyland et al., *The tyranny of international index rankings,* 97 J. DEV. ECON. 8 (2012) (measuring the uncertainty affecting DBR evaluations). Mistakes have similarly been highlighted in La Porta et al., *supra* note 8, at 1113; *see also* Holger Spamann, *The "Antidirector Rights Index" revisited,* 23 REV. FIN. STUD. 467 (2010) (finding that data reported for 33 out of the 46 surveyed countries were affected by coding errors, the correction of which falsifies the claim of the original study that common law outperforms civil law in terms of investor protection).

[34] The "Ease of shareholder suits" index includes a variable that measures the level of proof required for civil lawsuits. If this is lower than the burden of proof applicable to criminal cases, then the jurisdiction gets one point. Up to the 2012 Report, the variable scored 0 (*see* the Country Tbl. for Italy as of 2012). However, the correct indicator should have been 1 because under Italy's rules criminal liability requires proof of intentionality while civil liability is based on negligence, which is easier to prove. The mistake was fixed as from the 2013 report. As that variation did not reflect any law reform, the 2013 and 2014 Reports properly report no change over time in this respect: *see* Int'l Fin. Corp. [IFC], *Doing Business 2014 – Economy Profile: Italy*, DOINGBUSINESS.ORG, 60(Oct.29,2013),https://openknowledge.worldbank.org/bitstream/handle/10986/18495/828700ItalyoITA0Box0382099B00PUBLIC0.pdf?sequence=1&isAllowed=y. The same holds true for other rankings, which were consequently amended in retrospect (*id.*, at 57). Similar retroactive corrections are not exceptional: *see* INDEP. EVALUATION GRP., *supra* note 5, at 17. *See also* DU MARAIS, *supra* note 4, at 40, 54 (questions on the standard of evidence in the PII are framed according to common law legal tradition and might make little sense for civil law countries, thus leading to coding errors).

[35] *See* Art. 2 RPT Regulation (Consob Decision No. 17221 of 12 Mar. 2010, as amended; O.J. No. 152 of 2 Jul. 2010). We provide here an overview of the rules applicable to Buyer's transaction with Mr. James. For a more comprehensive description of the Regulation see Marcello Bianchi et al., *Regulation and self-regulation of related party transactions in Italy,* QUADERNI DI FINANZA CONSOB NO. 75, at 10-13 (2010); Organisation for Economic Co-operation and Development [OECD], *Related Party Transactions and Minority Shareholder Rights*, 115-6, (2012).

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leaving room for some optional choices.[36] Because the simulation of the DBR only considers default provisions, with few exceptions we limit our description to rules which apply to the PII hypothetical transaction by default.

The Regulation prescribes that the whole board shall be in charge of deciding whether the RPT is to be entered into. Therefore, no delegation of powers to the executives is allowed in this respect.[37] Before such a decision is made, however, a special committee – composed exclusively of unrelated[38] independent[39] directors – shall evaluate the substantial fairness of the affair as well as the company's interest in the transaction. The special committee has to be involved in the negotiations and internal decision-making process leading to the RPT approval. Not only the special committee is entitled to receive timely information on the ongoing negotiations, but it may also request clarifications on specific issues and provide comments to the executives throughout the process.[40] The committee may also ask for the advice of independent experts of its own choice. The company will bear the related costs for the additional expertise.[41]

The special committee can veto the transaction by releasing a binding advice. Alternatively, an express charter provision may opt out of the special committee voting requirement in favour of a double-majority quorum in the board of directors. The transaction may not be entered into unless the majority of the independent board members have approved it.[42] The

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[36] *See*, *e.g.*, Bianchi et al., *supra* note 35, at 13 (identifying the most relevant optional provisions).
[37] *See* RPT Regulation, *supra* note 35, art. 8(1)(a).
[38] For the purposes of the Regulation, directors are "unrelated" if they are neither the counterpart of the relevant transaction nor a related party thereof.
[39] Directors are deemed independent if they comply with the requirements set by the applicable corporate governance code. If the company does not conform to any code, then some default requirements apply (*see* RPT Regulation, *supra* note 35, art. 3(1)(h)).
[40] *See* RPT Regulation, *supra* note 35, art. 8(1)(b). Early involvement of independent directors enhances the quality of their review and improves the general rule requiring disclosure of conflicts of interests to the whole board when the final decision on the transaction is taken CODICE CIVILE [CIVIL CODE] [C.C.] art. 2391. The procedure therefore goes beyond the DBR methodology, where compliance with the general rule suffices to receive the maximum score (2) for the variable "whether disclosure of the conflict of interest by Mr James to the board of directors is required" (one point is given if a general disclosure that a conflict exists is mandated without any further specification, and no point otherwise).
[41] Companies may cap the total expenses for opinions concerning transactions of lesser importance.
[42] *See* RPT Regulation, *supra* note 35, art. 8(1)(c).

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Regulation,[43] however, allows companies to overcome the independent directors' binding negative advice - under the form of either a committee resolution or a double-majority quorum - through an ad hoc authorization by the shareholders' general meeting.[44] When the company opts for this opportunity, the applicable procedures shall ensure that the proposed transaction can only be entered into if it reaches the ordinary quorum and is approved by a majority of unrelated shareholders (so-called "whitewash" procedure).[45] Therefore, the transaction cannot be entered into if the majority of minority shareholders has voted against the transaction.[46]

Disclosure is mandated by specific provisions within the Regulation. These requirements are complementary to the general rules on ad hoc dissemination of internal information.[47] They require to disclose information in relation to, inter alia, the qualification of the transaction as RPT, the nature of the relationship with the related party (to be identified), the amount of the transaction, the procedure followed for approval, and the dissenting opinions – if any – within the board or the special committee.[48]

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[43] *See* RPT Regulation, *supra* note 35, art. 8(2).

[44] In April 2014, the E.U. Commission adopted a proposal to introduce an European-wide legislation on related party transactions. According to the proposal, shareholder approval shall be mandated before any such transaction is entered into which exceeds 5% of company's assets or which can have a significant impact on profits or turnover: *see* European Commission, *Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC Art. 9c(2)*, at 9, (2014).

[45] *See* RPT Regulation, *supra* note 35, art. 11(3). Companies' code and bylaws are allowed to establish that a minimum threshold, not higher than 10%, must be present at the GM in order to make the whitewash effective.

[46] The majority of the minority approval mechanism neutralizes the effects of the provision failing to impose abstention from voting on conflicted shareholders (C.c. art. 2373).

[47] According to Art. 114 and 181 of the Consolidated Law on Finance, enacting Commission Directive 2003/6/EC, Art. 6, companies shall immediately disclose inside information concerning transactions that, if made public, would be likely to have a significant effect on the price of their shares. In the DBR's methodology, no reference is made to how the transaction relates to ad hoc disclosure duties, possibly also because no such duties exist under U.S. law. Any evaluation on whether the DBR model transaction involves price sensitive information will be highly discretional, although the size of the consideration paid for the truck fleet is very likely to make dissemination necessary. Because the DBR treats Germany as a jurisdiction imposing immediate, detailed disclosure of Mr. James's transaction (*see* Int'l Fin. Corp. [IFC], *Doing Business 2014 – Economy Profile: Germany*, DOINGBUSINESS.ORG, 64 (Oct. 29, 2013),http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2014/05/01/000260600_20140501155900/Rendered/PDF/828430Germany0DEU0Box0382098B00PUBLIC0.pdf, where a scoring of 1 is assigned because the applicable rules require disclosure of the transaction, but not of Mr. James's interest), and such a conclusion can only be based on the ad hoc disclosure duties deriving from E.U. law (in the absence of specific disclosure duties relating to RPTs under German law), we will similarly assume in the following that Mr. James's transaction would trigger ad hoc disclosure duties in Italy as well.

[48] *See* RPT Regulation, *supra* note 35, art. 6; *see also* Commission directive 2003/6/EC, Art. 6(7).

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Regardless of the qualification of the RPT as inside information, detailed information must be published within seven days from the approval by the competent body or, when the circumstances so require, from the contractual proposal.[49] Such information is provided in accordance with a standardised format set by the Regulation that mandates disclosure of the terms of the transaction. Disclosure must, inter alia, specify the company's interest in the operation and describe the criteria adopted to define the consideration paid. Conflicting interests, including indirect interests, are to be divulged (e.g. when the managers' compensation is influenced by the performance of the RPT).[50]

Finally, annual and interim reports must provide information on individual major RPTs.[51]

5. MEASURING INVESTOR PROTECTION IN ITALY AFTER THE REGULATION ON RELATED PARTY TRANSACTIONS

According to the 2014 DBR, Italy does not reach the highest score in a number of sub-indexes (ten out of eighteen) within the PII. Furthermore, the DBR does not report, in its section displaying past performances, any variation in the applicable rules during the last years. The approval of the RPT Regulation (in 2010), as well as its entry into force (in 2011) have not been coded as relevant regulatory reforms for investor protection. Most of the scorings assigned adequately reflect Italy's current and previous legal and regulatory environment, while others do not.

Coding mistakes may lead to underestimate or overestimate the current level of investor protection in a given jurisdiction. They can also misrepresent the evolution of the applicable rules because inflated past scorings can hamper the registration of subsequent improvements. The reasons why some of the scores assigned to Italy inaccurately reflect the

[49] The questionnaire used to gather the relevant data only refers to information disseminated within 72 hours after the transaction is approved (Int'l Fin. Corp. [IFC], *Doing Business 2014. Measuring Business Regulation – Questionnaire*, DOINGBUSINESS.ORG, 5 (2014), http://www.doingbusiness.org).
[50] *See* RPT Regulation, *supra* note 35, art. 5 and Annex 4.
[51] *See* RPT Regulation, *supra* note 35, art. 5.

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national legal framework, either for the present or for the past, are manifold. In some cases, the scoring may simply be the result of a basic misunderstanding of the Italian legislation; in others, miscoding may stem from a formalistic interpretation – rather than a functional one – of the applicable rules or of the DB methodology itself. As a result, according to the DBRs, the Italian legal system has made no progress in recent years. According to the evaluation no noteworthy reform has been passed in 2010, or enacted in 2011.[52] Although the DBR team stated that "a rigorous reform effort will certainly be reflected in the DB indicators,"[53] regardless of whether it is intended to improve on DBR rankings we intend to show that the ranking fail to account for Italy's improved legal regime.[54]

In part 7, we analyse how mistakes in past assessments are responsible for delivering misleading information on the jurisdiction's legal developments. In this section, we highlight one inaccuracy in the coding of the legislation currently in force. In particular, the DBR fails to properly account for the function performed by the review of RPTs by independent directors and the ensuing veto power over unfair deals. We believe that the introduction of independent board members brought substantial change to Italian corporate practices: there is evidence that active shareholders can take advantage of the Regulation to successfully challenge RPTs.[55] This shows that the new legal devices which aim at protecting minorities are not just cosmetic.

While we acknowledge that one mistake is tolerable in assessing a country's legal protections for minority shareholders, we focus on this mistake for three main reasons. First, its impact on Italy's PII ranking is not

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[52] Int'l Fin. Corp. [IFC], *Doing Business 2012 – Economy Profile: Italy*, DOINGBUSINESS.ORG, 61-63 (Jan. 1,2012),http://www.wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2012/02/23/000333038_20120223235145/Rendered/PDF/653230Italy0Do0Box0365711B00PUBLIC0.pdf. *See infra* Fig. 1.
[53] Int'l Fin. Corp. [IFC], *Doing Business in Italy – Reform opportunities*, DOINGBUSINESS.ORG, 3 (2012), http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Subnational-Reports/DB13-Italy.pdf.
[54] *See* Organisation for Economic Co-operation and Development, *supra* note 35, at 117 ("Italy has made considerable progress in recent years to promote and defend shareholder rights and to improve transparency").
[55] *See* BELCREDI & ENRIQUES (2014), at 27-8 (reporting successful initiatives by Amber Capital LP at companies such as Fondiaria SAI and Parmalat).

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negligible. Indeed, it accounts for eighteen positions in the last DBR.[56] Second, it affects one of the core regulatory devices of the RPT Regulation, which has been implemented with the intent to ensure that conflicted transactions are entered into at fair conditions; the DBR's misunderstanding of the Italian regulatory framework is therefore much larger than what is shown by this single mistake. Third, this coding mistake reveals the challenges that the DBR evaluation encounters in balancing the objectivity of the evaluation while also carefully assessing peculiar solutions by individual jurisdictions.

Indeed, some of the procedural requirements in the RPT Regulation are admittedly unique. Therefore, it may be difficult to precisely allocate them into standardized legal framework models of the DBR simulation. That is the case with the special committee's binding advice on the RPT. The PII variable ascertains whether the corporate body provides sufficient legal approval for the transaction. The evaluation grid assigns a score of zero if the CEO alone can approve the RPT; one point is given if the board of directors or shareholders must vote on the transaction but "Mr James" is permitted to vote in his quality of board member or shareholder respectively; a score of two is assigned if the board approval is needed while "Mr James" is not permitted to vote; finally, a maximum score of three is granted if shareholders must vote on the transaction while "Mr James" has to abstain.

According to the DB team in charge of evaluating Italy, "[RPTs] are pre-approved by the independent directors' committee and approved by the board of directors. In addition, the new regulation allows the participation of the interested party in the approval process (board of directors). In addition, according to the new regulations, regardless of the committee's opinion, the board of directors (in which the interested party can vote) has the final say on the transaction. It is important to note that according to the new regulations, the committee of independent directors does not have the power to block or veto related-party transactions. Based on the methodology, Italy receives one point under this questions."[57] The team therefore assigned to

[56] *See infra* Tbl. 6.
[57] *See* DBR TEAM, Doing Business Project Response – Italy, 13 (Jul. 19, 2011) (unpublished manuscript) (on file with the authors).

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Italy a score of 1. The reported statement is inaccurate in describing the RPT Regulation and shows some misunderstandings on the functioning of its procedural safeguards. As clarified in section 4, the new regulation relies on the review of RPTs by a special committee of independent directors. Their power to veto the transaction is the primary tool for ensuring minority shareholder protection. More precisely, independent directors are involved in the negotiation. The board of directors' approval of the RPT is subject to binding favourable advice of a committee of independent directors. In other words, the committee of independent directors has a veto power on RPTs.[58]

The requirement for independent committee's binding opinion neutralizes the disgraceful choice by Italian lawmakers in 2003 not to disqualify interested directors from voting.[59] Interested directors cannot be members of the special committee which can veto the resolution.[60]

To conclude, according to the default regime, a negative advice from the independent committee of directors can block the RPT. Therefore, the appropriate score should be 2 instead of 1.[61]

As the coding we would deem appropriate at first sight does not correspond to that displayed by the DBR, in the next part we analyse more in depth the reasoning underpinning the DBR judgement and provide a critique thereto.

[58] The committee's binding advice is the default rule, but a double-majority quorum is required for opting-out companies. *See supra* note 42.

[59] C.c. art. 2391. To be sure, if the majority is reached and the interested director's vote is pivotal, the board resolution (as well as the RPT) is voidable in case it is harmful for the company.

[60] Nor can they count for independent directors' majority purposes in case companies have opted out of the default rule providing for the special committee's veto power. *See supra* note 58.

[61] To be sure, companies may opt out of the said regime via a charter amendment (to be approved by shareholders holding a two thirds majority of the capital represented at the meeting, according to the general rule: C.c. artt. 2368 and 2369, so that the independent committee does not have the final say on the RPT; but, whenever companies opt out this way, the power to approve the RPT is shifted to the general meeting upon the favourable vote of non-interested shareholders. If the optional regime is chosen, therefore, 3 should be the correct score. We leave this hypothesis out of the picture in the following, because the DBR focuses on default rules. If the pending E.U. Commission's proposal mandating shareholder approval is eventually to become law (*see supra* note 44 and accompanying text), Italy – as any other E.U. jurisdiction – will get 3 points for this variable.

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6. THE DBR EVALUATION. METHODOLOGICAL ISSUES

The DB team's explanations[62] show that the reason why the DBR assigns 1 to Italy despite the independent directors' veto power is twofold:

1. The case study assumes that the approval by the committee is a formalistic requirement (*see* part 2). The independent committee, therefore, does not have the final say on the RPT as the final approval is left to the board.
2. Interested parties may vote in the final decision of the board of directors.

Both points are formally correct. The DBR evaluation, however, fails to understand the regulatory mechanisms which underpin the Italian rules on RPTs. Indeed, according to this methodology, and to its implementation by the team, no difference exists between the current Italian regime and a regime where RPTs are approved by an ordinary vote of the board of directors. This is misleading because the two mechanisms – ordinary voting procedure and independent committee's veto – are unlikely to lead to the same outcome. Clear-cut categorizations always run the risk of misinterpreting regulations that do not perfectly fit into their classification (e.g. the Italian Regulation on RPTs). However, approaching law from a functional perspective seems more reasonable than engaging in a box-ticking exercise.

As regards the first statement above (the independent committee does not have the final say), what matters from a functional point of view is who bears the final responsibility to screen RPTs, rather than who has the final say on their positive approval. These two functions are usually commingled because directors may either approve or reject the proposal by casting a single vote. As a consequence, DB's methodology is based on this common voting pattern. On the contrary, the procedure set forth by the RPT Regulation somehow splits these two phases. Once a negative vote has been expressed by the committee of independent directors, the board can no

[62] DBR TEAM, Doing Business Project Response – Italy, 2 (Jul. 19, 2011) (unpublished manuscript) (on file with the authors).

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longer vote on the same matter. In other words, for investor protection purposes, it is indeed relevant whether someone other than "Mr James" and the board of directors can say "no" to the transaction. The fact that the whole board, which includes "Mr James" as a voting member, may still decide whether to approve the transaction is irrelevant. Indeed, a subset of independent and disinterested directors has already assessed that the proposed transaction is fair and useful. Hence, the evaluation grid – or, rather, its application – improperly assume that only mandatory abstention may avoid improper influence by interested parties. The methodology indeed regards any regulatory mechanism which deviates from this standard as inadequate, regardless of whether it delivers equally effective results.[63]

In Italy, only if the committee of independent directors has given its approval the board can still vote down the RPT. The approval by the committee is a governance device which is designed to ensure independent evaluation of the RPT's fairness in the light of the company's interest. The assessment exercise by regarding this approval as a preliminary authorization does not correctly evaluate regulatory strategies other than full board voting. The DBR evaluation, therefore, does not respect the principle, which is self-evident in comparative law, that different regulatory tools can achieve the same results. [64] According to the ill-founded interpretation of the DBR, when the vote is taken before and separately from the final approval of the RPT, investors are less protected when compared to regimes where the board approves the RPT without a dominant vote of the shareholders. It is true that any classification of legal rules requires a minimum level of

[63] *Cf.* Mathias Siems, *Measuring the Immeasurable: How Law Turns into Numbers,* in DOES LAW MATTER? ON LAW AND ECONOMIC GROWTH 115, 120-121 (Michael Faure & Jan Smits eds. 2011) (Djankov et al. methodology assumes that the same type of problem exists in all the jurisdictions considered, while this is far from obvious).

[64] More broadly, the DBR team's thinking (as we understand it) is a distortion of the assumption that all required approvals have been obtained (the same assumption is made by Djankov et al., *supra* note 8, at 432). The assumption enables an unambiguous assessment of criteria such as those included in the director liability index (*see, e.g.*, whether a shareholder plaintiff is able to hold Mr James liable for the damage the Buyer-Seller transaction causes to the company). The coding of these variables depends in fact on whether the transaction is carried out in breach of the applicable corporate rules, a possibility that the methodology rules out by making the assumption explicit. This being its function, the assumption includes the final approval by the CEO, the board, or shareholders, as the case may be (*see* Djankov et al., *supra* note 8, at 433: "Buyers enters into the transaction. All required approvals are obtained and all the required disclosures made"). The same prerequisite does not make much sense if referred to variables dealing with the procedure *for approving the RPT*, as it includes the variable to be measured (the final decision-making responsibility) in the assumptions.

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formalism, as a purely functionalist interpretation would pave the way to excessive subjectivity in the coding exercise.[65] On the other hand, by assuming that the positive approval by independent board members is a mere formality (i.e. regarding it as an irrelevant step in the voting process) rather than the first step of a multi-staged decision the team is also expressing a subjective opinion.

Moreover, although according to the RPT Regulation the special committee vote is the default mechanism it is also possible to opt for a double-majority quorum in the vote of the board of directors. Two logical consequences can be drawn from this information. First, no functional difference exists between the optional rule system where the two decisions, one by the plenum and the other by the majority of the independent committee, are merged into one and a system where these decisions are deferred to two separate moments. Therefore, because no one would ever regard the double majority requirement as a preliminary authorization with no practical value, the same should be true for functionally equivalent regulatory mechanisms. Second, by requiring "Mr James" to abstain the regulatory environment will be more effective – and here we come to the fact that interested parties are allowed to vote – because the board will not be able to approve resolutions in the presence of dissenting votes by the majority of independent directors.[66] Therefore, although according to the RPT Regulation interested directors may vote, the preliminary binding advice of the independent committee (i.e., vote) reaches the same outcome and goes even further. Indeed, even in systems where "Mr James" is not allowed to vote – and the methodology requires no more than that – his presence at the board meeting may significantly influence the resolution. The default device adopted by the RPT Regulation avoids this risk as non-independent directors

[65] *See* Armour et al., *supra* note 2, at 600-1 (suggesting to enlarge the set of relevant variables in order to reduce the risk that formalism prevails over functionalism).

[66] Note that the Djankov et al. paper requires, with respect to the general meeting approval, that "the transaction must be approved by disinterested shareholders" (*see* Djankov et al., *supra* note 8, at 434), not that interested shareholders are not allowed to cast their vote. This formulation of the variable – albeit referred to general meetings – better reflects the function of rules that prevent conflicting interests from determining the outcome of decisional processes. Mandatory abstention is the most straightforward, but not the only rule ensuring such a result.

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cannot be members of the special committee.[67] If compared to regulations which merely require "Mr James", as well as other non-independent board members, to abstain the Italian procedure for deliberating on RPTs ensures a higher level of protection. Indeed, at the special committee stage, directors who are disinterested in the specific transaction, but are still under Mr James's influence, and are less likely to disregard his preferences when voting, cannot be members of the committee.

From a methodological standpoint, it is worth noting that the decision to disregard the role of the special committee is acceptable only if the applicable legislation is interpreted from an extremely formalistic perspective. Even by adopting a formalistic approach, the qualification of the committee's approval as a normal authorization may still be questionable. Apparently, this formalistic approach wants to ensure that the evaluation is consistent across different jurisdictions. However, reliance on formalism to ensure consistency and objectivity can lead to mistaken conclusions. First, we have shown that formal classifications (e.g. the decision to classify the vote of independent directors as a preliminary authorization rather than as part of a multi-staged board decision) can also be arbitrary: arbitrariness and objectivity are hard to match. Second, by focusing on the qualification of procedural requirements rather than on their function, current coding practices could disregard essential features of corporate governance and misjudge the effectiveness of investor protection mechanisms.[68]

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[67] This being the reason why the double-majority voting is conceived of as a second best solution which requires an explicit choice by the company when the internal procedures are drafted.

[68] The approach followed by the DBR team when evaluating the Italian jurisdiction is not isolated. A similar (and symmetric) example is the maximum score (3; *see supra* note 61 and accompanying text) granted to France as a consequence of the provision: cf. CODE DE COMMERCE [C.COM.] [COMMERCIAL CODE] Artt. L225-41 and L225-40 (Fr.) that enables shareholders to vote on RPTs authorized by the board of directors: *see* Int'l Fin. Corp. [IFC], *Doing Business 2014 – Economy Profile: France*, WORLDBANK.ORG, 65 (Oct. 29, 2013), http://www.wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2014/04/30/000260600_20140430162822/Rendered/PDF/828360France0FRA0Box0382098B00PUBLIC0.pdf. First, the evaluation apparently disregards the fact that shareholder approval is required after the contract is entered into, and therefore does not represent a precondition for the transaction to be passed (*see* MAURICE COZIAN et al., DROIT DES SOCIÉTÉS 352 (2012); *see also* Enriques et al., *Related Party Transactions'*, in REINIER KRAAKMAN et al., THE ANATOMY OF CORPORATE LAW 168 (2nd ed 2009, Oxford University Press). Second, the transaction is valid even in case shareholder approval is refused (*see* Organisation for Economic Co-operation and Development, *supra* note 35, cit., at 64) although the directors who approved it may be liable for damages ((C.COM) Artt. L225-41 and L225-42); PAUL LE CANNU & BRUNO DONDERO, DROIT DES SOCIÉTÉS 500 (2013)).

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On the contrary, our analysis confirms that a functional approach[69] would make the DBR assessment more accurate.[70] This approach assumes –this assumption is not discussed upon in the present work – that the trust in benchmarking exercises helps fostering adequate legal reforms.[71] A comparative law study, if properly conducted, would indeed refrain from easily stating that a jurisdiction lacks a specific legal tool just because of the peculiarity of its regime. Rather, it would strive to look for alternative rules that, although formally different from the yardstick adopted as a basis for comparison, perform the same role.[72] Other legal tools are at least as effective as mandatory abstention from voting[73] regardless of whether they operate before the transaction is brought to the plenary session of the board. Indeed, only independent directors, which also have no interest in the transaction, can participate to the independent committee. The evaluation should reflect the fact that different legislative tools may perform better than conflicted members' abstention without additional costs. According to Konrad Zweigert and Hein Kötz,

> "[t]he question to which any comparative study is devoted must be posed in purely functional terms; the problem must be stated without any reference to the concepts of one's own legal system. Thus instead of asking, 'What formal requirements are there for sales contracts in foreign law?' it is better to ask, 'How does foreign law protect parties from surprise, or from being held to an agreement not seriously intended?'"[74]

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[69] *See, e.g.*, KONRAD ZWEIGERT & HEIN KÖTZ, INTRODUCTION TO COMPARATIVE LAW 32-47 (3rd ed. 1998).

[70] *See* Michaels, *supra* note 9; Michaels, *supra* note 16 (suggesting stronger integration between comparative economics and comparative law); Kerhuel & Fauvarque-Cosson, *supra* note 33, at 828. *See also* Ménard & Du Marais, *supra* note 4, at 76-7 (DBR neglects basic rules for an effective comparative study).

[71] We do not therefore enter the discussion on the nature and the merits of functionalism, a concept whose implications for comparative law are still highly debated (for an overview Michaels, *The Functional Method of Comparative Law, in* THE OXFORD HANDBOOK OF COMPARATIVE LAW 339 (Mathias Reiman & Reinhard Zimmermann eds. 2008). Rather, it is the DBR's approach itself that compares different jurisdictions with the purpose of evaluating their relative efficiency (*see id.* at 373-6); a proper application of the functional method, as opposed to formalism, would be more consistent with the DBR's assumptions.

[72] John Reitz, *How to Do Comparative Law*, 46 AM. J. COMP. L. at 621 (1998) (on comparative law methodology).

[73] *Id.* at 623 (each jurisdiction may conform in different ways to the ideal legal tool adopted as a term of comparison).

[74] ZWEIGERT & KÖTZ, *supra* note 69, at 34.

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Comparative legal studies therefore necessarily entail some degree of generalisation. Searching for rules performing equivalent functions requires abandoning formal definitions in favour of broader categories which are capable of including rules which, though formally different from a formalistic perspective, achieve the same normative result.[75] By inspecting which formalities are required to approve the conflicted transaction, the DBR methodology assumes that board approval without "Mr James's" vote is the second most effective governance device (after minority shareholder approval) in ensuring fairness. However, it falls short of asking the correct question: "does the relevant jurisdiction protect external investors by shielding the approval of the transaction from Mr James's conflicted interest, i.e. by ensuring that the transaction is not passed if disinterested board members do not agree?" This question emphasizes the objective of the assessed regulation (sterilization of "Mr James's" interests in board decision), rather than the external features thereof (Mr James's abstention, double majority, preliminary vote by disinterested members, or other devices).

7. THE IMPACT OF MISCODING

It is mainly in the dynamic evolution of applicable legislation that one can see how indicators influence national policies.[76] The DBR provides a diachronic perspective on legal reforms. Indeed, year-on-year changes highlight whether a country is committed to improve its regulatory environment.[77] Flat performances or lost ground in the rankings may indicate that policymakers are not paying attention to areas of law that are pivotal in boosting economic growth.[78] The DBR's focus on trends in regulatory reforms therefore provides interested stakeholders with valuable

[75] Reitz, *supra* note 72, at 625 (comparative analysis … forces the comparatist to articulate broader categories to accommodate terms that are … functional equivalents).
[76] *See* DAVIS et al., *supra* note 8, at 11 (2012) (on indicators as "technologies" of governance).
[77] Historical data are also useful to test the relative attractiveness of a country over time, thus removing the influence of transient conditions on rankings (*see* John Armour et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origin Hypothesis*, 6 J. EMPIRICAL LEGAL STUD 343, 350-353 (2009)).
[78] Of course, this would just be a rebuttable presumption, so to speak, because a country may be even more committed to reforms than others higher in DBR rankings, and just choose to do it "its own way.".

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information. Indeed, potential investors can compare legislations in different countries whilst having a full picture of the evolutionary stages within the same jurisdiction.

In this respect, the attribution of an erroneously high score to a country in a certain year may paradoxically entail an underestimation of subsequent reforms. Therefore, even when substantial improvements have been achieved the chart might still show that the legal system of a jurisdiction had no improvements. Once more, Italy provides some good examples, because two variables within the PII were wrongly coded prior to the RPT Regulation's enactment.

The first miscoding was about whether self-dealing transactions such as the one hypothesized in the DBR had to be disclosed in the annual accounts: the DBRs preceding 2012 assigned a 2 score (that is: "disclosure on both the terms and Mr James's conflict of interest is required"[79]). This means that respondents to the questionnaire stated that the transaction should indeed have been disclosed in detail in annual accounts.[80] However, while before the RPT Regulation the law generically required companies to disclose the relations with their controlled, affiliated and controlling entities as well as with other entities under common control, the provision, according to the predominant interpretation, did not require a detailed disclosure of individual self-dealing transactions.[81] Therefore, even after the implementation of IFRS the consistent accounting practice of listed companies was not to include detailed information on these transactions.[82]

[79] Within this variable, a score of 1 is assigned if disclosure on the terms of the transaction is mandated, but not on Mr James's conflict of interests; 0 is assigned otherwise.

[80] A similar mistake affects the Djankov et al. paper's coding: *see* Luca Enriques et al., *Corporate Governance Reforms in Italy: What Has Been Done and What Is Left to Do*, 10 EUR. BUS. ORG. L. REV 477, 503-504 (2009).

[81] *See* Giovanni Emanuele Colombo, *Il bilancio d'esercizio* [*The Financial Statement*], in TRATTATO DELLE S.P.A. 157 (Giovanni Emanuele Colombo & Giuseppe Benedetto Portale eds., UTET 1994).

[82] *See* IAS 24, § 18 (allowing the aggregation of related party transactions provided that a distinction among categories of transactions is given). *See also* OIC, 140 (2007). Companies used to aggregate related party transactions in their annual reports before the RPT Regulation entered into force (*see* CONSOB (2008), Consultation document on the regulation of related party transactions).

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The RPT regulation has later specifically required annual, as well as the half-yearly financial reports to disclose,[83] self-dealing transactions falling above the materiality threshold.[84] Before the regulation was enacted, 0 would have been the appropriate score.

In the same vein, before 2012 DBRs assigned a score of 2 for the variable "Whether immediate disclosure of the transaction to the public and/or shareholders is required?".[85] Before the RPT Regulation entered into force, a mandate for immediate disclosure of RPTs would either derive from the general rule requiring ongoing disclosure of price sensitive information[86] or from a Consob rule requiring ad hoc disclosure for certain RPT (Art. 71-II Issuer Regulation, in place between 2001 and 2010). A transaction like the Buyer's would be very likely to fall within the scope of the ongoing disclosure obligations.[87] Therefore, the proper rating would have been 1 (as no disclosure of Mr James's conflict of interest was explicitly mandated). According to Art. 71-II of Consob Issuer Regulation, the conditions for triggering an obligation to disclose were so hazy that very few transactions had been made public under the rule. More specifically, only transactions which could have jeopardized the issuer's financial stability or the reliability of its financial account – according to the issuer's own judgment – had to be disclosed. As the case study is not assuming that these conditions are met, it cannot be established whether "Mr James's" transaction had to be disclosed pursuant to Art. 71-II. By contrast, under the RPT Regulation in force since 2011,[88] companies, when disseminating price sensitive information, are required to declare relationships with the other parties of the transaction

[83] For interim financial reports, Council Directive 2007/14, art. 4, 2007 O.J. (L 69) 27 (EC), implementing Council Directive 2004/109, art. 5(4), 2004 O.J. (L 390) 38 (EC), requires information on individual transactions that have taken place in the first six months of the financial year to the extent that they have materially affected the financial position or the performance of the enterprise during that period, as well as major developments thereof.
[84] *See* RPT Regulation, *supra* note 35, art. 5(8) (listed companies shall provide information, in the interim and annual reports, on each material transaction entered into during the reporting period).
[85] Within this variable, a score of 1 is assigned if disclosure on the terms of the transaction is mandated, but not on Mr James's conflict of interests; 0 is assigned otherwise.
[86] *See supra* note 47 and accompanying text.
[87] *See supra* note 47 and accompanying text.
[88] *See* RPT Regulation, *supra* note 35, art. 6(1)(a).

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which might result in a conflict of interest.[89]

Once the suggested coding corrections are considered, the misleading impression that nothing relevant has been done in recent years fades away. Table 1 and Figure 1 below display the DBR coding with the adjustments we deem appropriate.[90]

Table 1

	Extent of Disclosure Index (Sub-Variables)	*2011 Adj.*	*2012 on Adj.*
1	What corporate body provides legally sufficient approval for the transaction?	1	2*
2	Whether disclosure of the conflict of interest by Mr James to the board of directors is required?	2	2
3	Whether immediate disclosure of the transaction to the public and/or shareholders is required?	1**	2
4	Whether disclosure of the transaction in published periodic filings (annual reports) is required?	0**	2
5	Whether an external body must review the terms of the transaction before it takes place?	0	0
	Extent of Disclosure Index	4	8

* The variable is adjusted to reflect the role of the binding opinion by the independent directors' committee (see parts 5 and 6).

** The variables are adjusted to reflect the situation prior to the full RPT Regulation's entry into force (Jan., 2011), where no explicit duty to immediately disclose Mr James's conflict of interest was provided for and no ad hoc disclosure was mandated in the annual accounts.

[89] Furthermore, listed companies shall issue, within seven days of the approval, an information document whose contents are set by the Regulation itself and encompass all the features of the transaction as well as a detailed disclosure of James's interests (*see supra* note 49 and accompanying text; *see* RPT Regulation, *supra* note 35, art. 5(1) and (3); *see also* RPT Regulation, *supra* note 35, Annex 4). Although such information is more detailed than that provided for under RPT Regulation, *supra* note 35, art. 6(1)(a), it goes far beyond what is necessary to reach a score of 2 for the variable "Whether immediate disclosure of the transaction to the public and/or shareholders is required?". We therefore leave it aside because the questionnaire sent to local experts – although the methodology is silent on the point – focuses only on disclosure to be performed within seventy-two hours after the transaction is approved (*see supra* note 49 and accompanying text).

[90] In order to account for the overall impact of miscoding by the DBR, Tbl.1 and Fig.1 report all mistakes we identified, whether attributable to basic misunderstandings of the applicable rules (as explained in pt. 7) or to an unduly formalistic interpretation of the regulatory framework (as explained in pt. 6).

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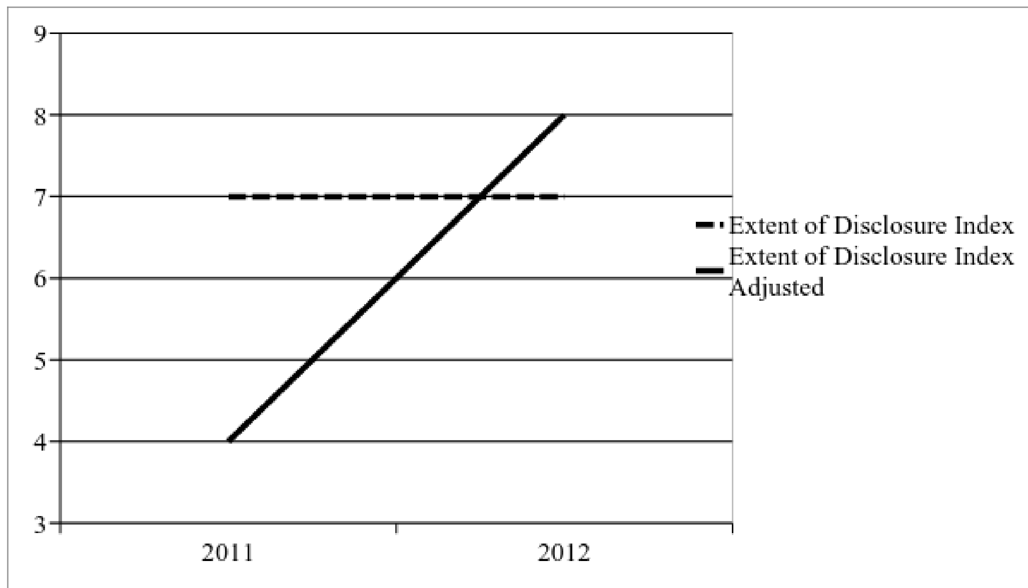
Figure 1



Graphic: adjusted rankings for Italy (Extent of Disclosure Index)

By the same token, Tables 2 to 5 and Figure 2 show that Italy would have ranked much worse in 2011 (93rd instead of 59th), and would have held a much better position in 2012, when the benefits of the Regulation were to be assessed for the first time (29th instead of 65th), as well as in the last available survey at the time of writing (2014: 32nd instead of 49th).

Table 2

	2011 Original	***2011 DBR Corr.***	***2011 Adj.*****
Protecting Investors (rank)	59th	44th	93rd
Extent of disclosure index	7	7	4
Extent of director liability index	4	4	4
Ease of shareholder suits index	6	7*	7
Strength of investor protection index	5.7	6	5

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Table 3

	2012	***2012 DBR Corr.***	***2012 Adj.*****
Protecting Investors (rank)	65th	46th	29th
Extent of disclosure index	7	7	8
Extent of director liability index	4	4	4
Ease of shareholder suits index	6	7*	7
Strength of investor protection index	5.7	6	6.3

Table 4

	2013	***2013 Adj.*****
Protecting Investors (rank)	49th	32nd
Extent of disclosure index	7	8
Extent of director liability index	4	4
Ease of shareholder suits index	7	7
Strength of investor protection index	6	6.3

Table 5

	2014	***2014 Adj.*****
Protecting Investors (rank)	52nd	34th
Extent of disclosure index	7	8
Extent of director liability index	4	4
Ease of shareholder suits index	7	7
Strength of investor protection index	6	6.3

* In Tables 2 and 3, in the "[year] Corr." column, the variable "Ease of shareholder suits index" is 7 – instead of 6 – so as to reflect the appropriate coding of the variable

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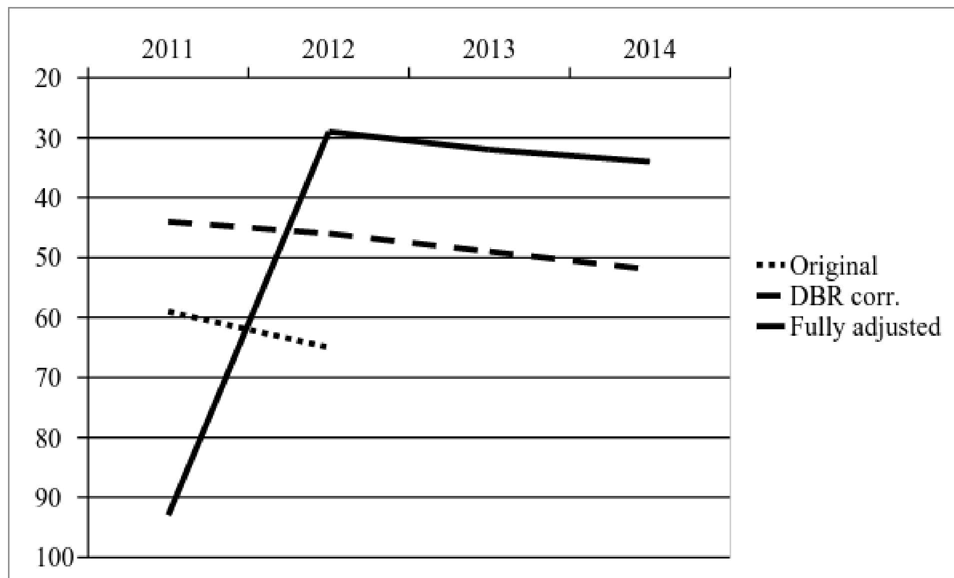
"Whether the level of proof required for civil suits is lower than that of criminal cases?" as subsequently rectified by the DB team (*see supra* note 34 and accompanying text).

** In Tables 2-5, the "[year] Adj." column displays the appropriate coding in light of our analysis.

Figure 2



Graphic: adjusted rankings for Italy (Protecting Investors Index)

Therefore, while no improvement and a relative loss in competitiveness emerge if one compares years up to 2011, on the one hand, and years since 2012, on the other, the adjusted variables highlight that Italy has actually gained fifty-nine positions as of 2014 in comparison with 2011. Inaccuracies of the DBR are summarised in Table 6, which measures their impact on the ranking of Italy in 2011 and 2014.

Table 6

Investor protection Index	***Original Ranking (1)***	***DBR Corr. Ranking (2)***	***Adj. Ranking (3)***	***Δ (3) – (1)***	***Δ (3) – (2)***
2011	59 (5.7)	44 (6)	93 (5)	- 34	- 49
2014	n.a.	52 (6)	34 (6.3)	n.a.	+ 18
Variation (positions)	n.a.	- 8	+ 59	n.a.	+ 67

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8. CONCLUSIONS: FUNCTIONAL APPROACH AND TRANSPARENT ASSESSMENT

The DBR has provided developing and developed countries with incentives to adopt more effective economic regulation by persuading policymakers that sound rules may enhance competitiveness and that cutting back on regulatory costs and red tape are key ingredients of economic growth.[91] Accuracy in the preparation of rankings is however essential to avoid that inadequate assessments convey distorted incentives to local reformers. Our analysis reports some coding errors that affect or have affected DBR's assessment of Italy's investor protection regime. Some mistakes are simply the result of erroneous interpretations of the applicable rules (e.g. the scoring on the mandatory individual RPTs disclosure in the annual accounts) (part 7). Others are methodological (e.g. the identification of the body providing legally sufficient approval for the transaction). Indeed, they fail to recognise that the procedural guarantees set forth by the Consob RPT Regulation are, in fact, more effective than the relevant DBR variables on board approval (part 6).

No ranking system can be perfect, as quantitative evaluations require a certain degree of simplifications.[92] However, some strategies may be adopted so as to improve the accuracy of the DBR assessment, as well as the shortcomings which affect the evaluation of the Italian legal framework for RPTs transactions. There is room for improving the coding process in the formulation of these indicators. Although the DBR assessment is already following some best practices for scoring exercises (e.g., publication is made of the identity of the experts providing the first set of information concerning the relevant national provisions[93]), its transparency is still insufficient when it comes to justifying unclear coding decisions.[94]

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[91] *See, e.g.*, Ménard & Du Marais, *supra* note 4, at 67 (notwithstanding their imperfection, DBRs have the merit of having put high on the agenda the analysis of institutions as a key factor for understanding development and growth); INDEP. EVALUATION GRP., *supra* note 5, at 44 (same).

[92] *See* Siems, *supra* note 2, at 529.

[93] Other organizations providing indicators are not equally transparent: for a sample review see Nikhil K. Dutta, *Accountability in the Generation of Governance Indicators*, GOVERNANCE BY INDICATORS. GLOBAL POWER THROUGH QUANTIFICATION AND RANKINGS 43, at 449-450 (Kevin E. Davis et al. eds. 2012).

[94] *See* INDEP. PANEL, *supra* note 9, at 5 (suggesting publication of contributors' submissions so as to allow external users to gauge the level of uncertainty associated to each index).

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Furthermore, the reliability of the rankings may improve by providing for external review of the decisions of the DBR. This would reduce the risk that institutional inertia, as well as confirmation biases, could produce inaccurate final indicators even when the outcome of the process is prone to clerical rather than methodological errors.[95]

Besides making the coding process subject to review and explaining borderline cases in the national reports, the methodology should always follow a more functional approach. By focusing on the function of the rule under scrutiny rather than on its formal features the highlighted drawbacks could be substantially reduced. In particular, this approach would introduce at least two improvements. Firstly, before rankings are made a more accurate knowledge of the societal context of the assessed jurisdictions would have to be obtained.[96] By assessing the scrutinized rules in coordination with other legal and economic features the concerned jurisdictions may deliver more complete results. Indeed, in order to perform a statistical analysis the DBR relies on an unrealistic set of rules that make it prone to simplification.[97] Second, any set of regulatory standards will be unlikely to include all relevant investor protection laws: complete information would be difficult to collect and to handle. In this scenario, a functional approach can improve the quality of the assessment by avoiding the risk of circularity which is one of the major flaws of the formalistic approach. Indeed, the latter relies on the assumption that only specific legal devices can assure effective investor protection, and therefore it disregards the alternatives which do not fit into the grid.[98]

As a consequence of the DBR methodology, countries wishing to reform their regulation on investor protection may be incentivised to adopt a box-ticking approach and pass regulations that reflect the evaluation grid of the DBR even if investors have no benefits from the reform. For instance,

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[95] *See* Dutta, *supra* note 93, at 440. According to INDEP. PANEL, *supra* note 9, at 5, 29-30 miscoding might be more easily avoided if risk-mitigation devices, such as external reviews, were included in the assessment process.
[96] On the epistemic role of a functional approach see Michaels, *supra* note 16, at 3-4.
[97] *See id.*, at 12, on a statistical reductionism.
[98] An underlying home bias may explain the selection bias, as a consequence of the natural tendency for those involved in the preparation of the assessment grid to prioritise legal solutions in place in the jurisdictions of origin (*see supra* note 31 and accompanying text).

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Italy would gain a number of positions in the PII ranking by amending a small number of legal provisions in a fashion that would not substantially improve the current level of minority protection. For instance, mandated abstention for "Mr James" could be introduced. As we have shown, this reform would have almost no impact on his ability to influence the company's decision. Secondly, as long as the DBR focuses on default rules,[99] Italy's performance would further improve by requiring shareholders to approve the transaction, while still granting companies the possibility of opt-outing and of granting independent directors a veto power.[100] Once more, there is no evidence that this would strengthen investor protection. Controlling shareholders could easily circumvent the default rule by amending the charter. Thirdly, as the Consob RPT Regulation allows independent directors to appoint an external adviser of their choice but does not mandate it,[101] imposing fairness opinions would boost Italy's performance.[102] However, the legal and economics literature often has doubts about the reliability of board-appointed external experts.[103] For this reason, their appointment is not compulsory.[104]

[99] *See supra* note 61 and accompanying text.
[100] A similar solution would be ruled out, though, if the E.U. Commission's proposal on the approval by general meeting of significant related party transactions were adopted (*see supra* note 44 and accompanying text). In the proposal, shareholder vote is mandated with no possibility of opt-outing.
[101] *See supra* text accompanying note 41.
[102] *See* Tbl. 1, line 5.
[103] *See, e.g.*, Jonathan R. Macey, *The Regulator Effect in Financial Regulation*, 98 CORNELL L. REV. 621 (2013) (fairness opinions are aimed at providing protection against litigation risk rather than conveying useful information to directors and investors; external experts have an incentive to deliver opinions aligned with the results preferred by the company's board); Darren J. Kisgen et al., *Are Fairness Opinions Fair? The Case of Mergers and Acquisitions, 91* J. FIN. ECON. 179 (2009) (fining evidence that fairness opinions in M&A transactions provide little value to shareholders of target firms, while results are mixed for acquiring firms' shareholders); Steven J. Cleveland, *An Economic and Behavioral Analysis of Investment Bankers When Delivering Fairness Opinions*, 58 ALA. L.R. 299 (2006) (reputational concerns provide weak constraints on investment bankers having an incentive to align their opinion with their clients' wishes).
[104] Macey, *supra* note 103, at 622-3 absent Delaware courts' de facto mandate for fairness opinions, these would perform their function better); Nina Walton, *Delegated Monitoring: When Can Boards Rely on Outside Experts?*, 14 AM. L. & ECON. REV. 271, 276-277, and 295 (2012) (when second opinions are deemed useful to convey relevant information to the market, companies are likely to spontaneously resort to them. When this is not the case because the external experts are prone to conflicts of interests, mandating a fairness opinion will unduly certify the transaction to the detriment of investors).

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If the measures we have hypothesized above were introduced, Italy's Extent of Disclosure Index could reach 10.[105] The PII would subsequently jump to 7,[106] and, ceteris paribus, the DBR for investor protection ranking Italy would be 16th in the DBR ranking. As shown, investor protection would not substantially improve.

The current methodology therefore incentivises convergence to a single set of legal devices and inevitably rules out idiosyncrasies or, at least, makes them harder to evaluate. Therefore, it discourages the implementation of new legal devices which would lower the costs of implementation whilst ensuring the same level of investor protection. In other words, homologation trumps experimentation.[107] By contrast, a functional evaluation would increase flexibility,[108] which is pivotal in the field of investor protection because tunneling techniques change over time in accordance with the relevant legal framework.[109] Therefore, like in a cops and robbers game, it requires the continuous testing of new legal strategies.

[105] A mandatory fairness opinion would add one point on the score of 7 currently assigned for the extent of disclosure index. Mandatory Mr James's abstention would add another point, while shareholder involvement – a measure alternative to Mr James's abstention – would add two points.

[106] PII is in fact the average of the Extent of Disclosure Index (which would increase to 10), the Extent of director liability index and the Ease of shareholder suit index (which would respectively remain 4 and 7).

[107] Larry Ribstein & Bruce Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEGAL STUD. 131, 140-141 (1996) (uniform laws determine a lower degree of experimentation).

[108] On the role of functionalism in the production of rules see Michaels, *supra* note 16, at 4. INDEP. PANEL, *supra* note 9, at 23, suggests reviewing the Indexes periodically in order to reduce selection biases.

[109] Vladimir Atanasov et al., *Law and Tunneling*, 37 J. CORP. L. 1 (2011) (analysing different tunneling techniques and anti-tunneling strategies, and claiming that there is no broad consensus on which rules are better suited to protect investors).

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The Single Supervisory Mechanism: the Building Pillar of the European Banking Union

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TABLE OF CONTENTS: 1. The Origins of the European Banking Union; 2. The Rationale Behind a Centralized Supervision; 3. The Single Supervisory Mechanism (SSM). Scope, Division of Tasks and Cooperation Within the SSM; 4. Non-participating Member States. The Opt-in Regime; 5. The Impact of the SSM on the Supervision of Cross-border Banking Groups; 6. The ECB as a Prudential Supervisor. Governance and Powers; 7. The Relationship Between the ECB and the Other E.U. Supervisors; 8. Balances and Perspectives of the SSM.

ABSTRACT: One of the lessons learned from the 2008 financial crisis is that when a bank in Europe goes into trouble the ensuing effects can reach far beyond the immediate threat to its depositors and shareholders. In particular, the crisis has revealed the extent to which irresponsible behavior in the banking sector could undermine the foundations of the financial system and threaten the real economy by turning a banking crisis into a sovereign debt crisis, as occurred in the Eurozone in 2011. In response to this lesson, Member States first tried to address the systemic fragility of their banking systems through national policy tools. The interdependency of countries which share a common currency however required more integrated responses. Therefore, at the euro area summit in June 2012, the European Council agreed to break the vicious circle between banks and sovereign debt by creating a banking union. The union would institute a centralized supervision for banks in the euro area through a newly established Single Supervisory Mechanism (SSM). The SSM, which became operational in November 2014, represents the building pillar of the banking union. After a brief description of the causes that led to the introduction of the European banking union and of the rationale behind a centralized approach to supervision (Par. 1 and Par. 2), this paper purports to analyze the SSM and illustrate its functioning (Par.3) and impact on cross-border banking groups (Par. 4). The analysis then shifts its focus on the position and powers of the ECB within the SSM and on its relations with the European authorities introduced in 2010 (Par. 5 and Par. 6). Finally, this work remarks a few aspects of the balances and perspectives of the new regime (Par. 7).

KEYWORDS: *Single Supervisory Mechanism*; *SSM*; *European Banking Union*.

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1. THE ORIGIN OF EUROPEAN BANKING UNION

The recent financial crisis helped regulators to discover that when a bank in Europe goes into trouble the ensuing effects can reach far beyond the immediate threat to its depositors and shareholders. In particular, the crisis has revealed the extent to which irresponsible behavior in the banking sector could undermine the foundations of the financial system and threaten the real economy by turning a banking crisis into a sovereign debt crisis. This scenario describes the situation of the Eurozone in 2011.

Since 2008 there has been a strong correlation between the finances of Eurozone banks and the sovereign debts of its Members. This correlation has created a vicious cycle between bank risks and sovereign risks.

In countries where domestic supervisors acted in an overly permissive fashion towards national champions,[1] public finances absorbed the costs of the crisis and, therefore, inevitably deteriorated.[2] Examples are offered by Ireland and Spain, where the rescue of failing banks has drained huge amounts of public resources.[3] In other countries events evolved differently. For instance, in Greece and, to a lesser extent, Italy huge public debts

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[1] *See* EDDY WYMEERSCH, *The European banking union, a first analysis* (Fin. Law Inst., Working Paper No. 07, 2012), http://ssrn.com/abstract=2171785; Luigi Federico Signorini, Direttore Centrale per la Vigilanza bancaria e finanziaria, Banca d'Italia, 6ª Commissione permanente del Senato della Repubblica (Finanze e Tesoro), *L'Unione bancaria* (Oct. 24, 2012),https://www.bancaditalia.it/pubblicazioni/interventivari/intvar2012/unione_bancaria_signorini.pdf, and GUIDO A. FERRARINI & LUIGI CHIARELLA, *Common Banking Supervision in the Eurozone: Strengths and Weaknesses* (ECGI Law, Working Paper No. 223, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2309897. In order to promote the local banking systems, some supervisors did not adequately counter risky behaviors of intermediaries, such as granting credit to certain sectors of the economy like real estate.

[2] *See* JEAN PISANI-FERRY, ANDRÉ SAPIR, NICOLAS VÉRON & GUNTRAM B. WOLFF, *What Kind of European Banking Union?*, BRUEGEL.ORG (Jun. 25, 2012), http://www.bruegel.org/publications/publication-detail/publication/731-what-kind-of-european-banking-union, emphasizing that banks that were European in ordinary circumstances have become national in crisis times, as they depend on national governments for support.

[3] *See* DOUGLAS J. ELLIOTT, *Key issues on European banking union* (Glob. Econ. & Dev., Working Paper No. 52, 2012), http://www.capitalis.com/admin/white_papers/file188.pdf, noting that in Ireland and Spain, failing banks added massive liabilities to the balance sheets of the sovereigns, weighing them down.

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affected domestic banks as a result of the strong domestic component of their bond portfolios.[4]

Under such circumstances, national politicians, as well as public authorities, tried to avoid burdening taxpayers for the consequences of credits that national banks had spread to other jurisdictions.[5] Banks and national supervisors restricted the circulation of liquidity between countries, including transfers of capital within cross-border banking groups. As a result, the interbank markets ceased to function: intermediaries preferred to allocate liquidity into non-interest bearing deposits at the European Central Bank. In addition, significant funds were moved from peripheral countries to central jurisdictions, even though the interest rates offered by the latter produced negative returns in real terms.[6]

Additionally, the mechanism of monetary policy also came to a halt: this highlighted the pivotal role of financial integration in a well-functioning of the Monetary Union.[7] In particular, the financial system of the Eurozone is fragmented along national borders[8] which leads to the formation of severe macroeconomic imbalances.[9] The remuneration of bank deposits and the interest rates paid on bank loans diverged considerably between countries. Despite the European Central Bank set the same level of reference rate for monetary policy, the costs of credit to households and businesses varied

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[4] *See* Benoît Coeuré, Member of the Exec. Bd., European Cent. Bank, *Why the euro needs a banking union* (Oct. 8, 2012), http://www.ecb.int/press/key/date/2012/html/sp121008_1.en.html.

[5] *See* PISANY-FERRY, SAPIR, VERON & WOLFF, *supra* note 2, arguing that banks have been encouraged by national authorities to cut cross-border lending, which is understandable from a national viewpoint. However, the pursuit of national policies to fight the crisis has not led to financial stability.

[6] *See* ELLIOTT, *supra* note 3, at 14.

[7] *See* Vítor Constâncio, Vice-President of the ECB, *Towards a European Banking Union* (Sep. 7, 2012), http://www.ecb.int/press/key/date/2012/html/sp120907.en.html, arguing that a high degree of financial integration, where financial institutions diversify their assets and liabilities across eurozone countries, is essential for an effective transmission of monetary policy. Imperfect financial integration complicates the task of the central bank in a currency union making it more difficult to achieve a uniform impact in the transmission of monetary policy and ensures uniform levels of interest rates across countries. It is therefore essential to reverse this fragmentation and restore the proper transmission mechanism of monetary policy. *See also* EUROPEAN CENT. BANK, *Financial integration in Europe*, ECB.EUROPA.EU (Apr. 2009),http://www.ecb.eu/pub/pdf/other/financialintegrationineurope200904en.pdf; André Uhde & Ulrich Heimeshoff, *Consolidation in Banking and Financial Stability in Europe: Empirical Evidence*, 33 J. BANK. & FIN., 1299 (2009). *See also*, A.SAPIR & G.B. WOLFF, *The Neglected Side of Banking Union: Reshaping Europe's Financial System*, BRUEGEL.ORG (Sep. 13, 2013),http://bruegel.org/2013/09/the-neglected-side-of-banking-union-reshaping-europes-financial-system/.

[8] *See* EUROPEAN CENT. BANK, *Financial integration in Europe*, ECB.EUROPA.EU (Apr. 2012), https://www.ecb.europa.eu/pub/pdf/other/financialintegrationineurope201204en.pdf.

[9] *See* WYMEERSCH, *supra* note 1, at 6.

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substantially between Eurozone countries. The highest costs were recorded in the countries with the weakest economic conditions. Therefore, rather than a single currency, there were as many "euros" as countries in the Monetary Union.

In reaction to this economic scenario, Member States first tried to address the systemic fragility of their banking systems through national policy tools. These measures were however insufficient: indeed, as countries that share a common currency are more inter-dependent they required more integrated responses. Therefore, at the euro area summit in June 2012[10] the European Council in order to break the vicious circle between banks and sovereign debt introduced a banking union so as to provide centralized supervision for banks in the Eurozone. These objectives were realized by establishing the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). Whereas the former is devoted to the monitoring of banks in the euro area, the latter provides a centralized resolution system for credit institutions.[11]

Consequently, on the 12th of September 2012, as part of a roadmap towards the establishment of the SSM as the building pillar of the banking union in the Eurozone,[12] the European Commission published a Regulation proposal which conferred supervisory tasks on the European Central Bank

[10] On May 23, 2012, the European Council - in order to "strengthen economic union and make it commensurate with the monetary union" - asked president Van Rompuy and other top European officials to identify "building blocks", among which "a more integrated banking supervision and resolution, and a common deposit insurance scheme" - in short, a banking union: *see* Herman Van Rompuy, President, European Council, Remarks Following the Informal Dinner of the Members of the European Council (May 24, 2012), http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/130376.pdf. On June 19, 2012, the G20 leaders expressed support for "the intention to consider concrete steps towards a more integrated financial architecture, encompassing banking supervision, resolution and recapitalization, and deposit insurance": *see* G20 Leaders Declaration (Jun. 19, 2012), http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/131069.pdf.
On June 29, 2012, the euro area Heads of State or Government called on the Commission to present proposals to provide for a single supervisory mechanism involving the ECB – *See* how the European Council concluded, (Jun. 29, 2012), http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131388.pdf. On the euro area Summit of June 2012 *see* Pedro Gustavo Teixeira, *The Single Supervisory Mechanism: Legal and Institutional Foundations*, QUADERNI DI RICERCA GIURIDICA DELLA BANCA D'ITALIA, March 2014, at 73.

[11] *See* Jens-Hinrich Binder, *The European Banking Union - Rationale and Key Policy Issue in* THE EUROPEAN BANKING UNION: A COMPENDIUM 1 (Jens-Hinrich Binder & Christos V. Gortsos eds., 2015).

[12] *See* European Commission Proposal [hereinafter SSM Commission Proposal] for a Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions COM (2012) 511 final (Sep. 12, 2012), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0511:FIN:EN:PDF.

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(ECB). The Regulation provided the ECB with a clear mandate and broad direct and indirect supervisory powers on all Eurozone banks.

The Commission also gave new impetus to the European legislative project (CRR/CRD IV) which, according to the 20th recommendation of the De Larosière Report,[13] was expected to overcome the inconsistencies caused by different implementations of the European Directives on banking and supervision between national legislations.[14] On the 12th of June in 2012, the Commission presented a Draft Directive with the intent to harmonize and strengthen national banks resolution mechanisms.[15] The Commission also proposed the establishment of a SRM for the euro area. One year later on the 10th of June, this project was formalized in a Draft Regulation Proposal.[16] In greater detail, this proposal placed the Single Resolution Board at the top of the SRM hierarchy. This decision-making body was established to secure the resolution of the serious difficulties of credit institutions with minimal costs to taxpayers and to the real economy. For the same purpose, the proposal also included the establishment of a Single Resolution Fund. With the aim of further harmonizing national DGS, the original banking union roadmap also provided for the quick approval of the Directive on Deposit Guarantee

[13] The De Larosière Report is available on the E.U. Commission's website http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf;for a comment, see Guido Ferrarini & Filippo Chiodini, *Regulating Cross-border Banks in Europe: A comment on the De Larosière Report and a Modest Proposal*, 1 CAP. MKT. L. J., 123 (2009).

[14] *See* European Commission Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms COM (2011) 0453 final (Jul. 20, 2011), http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52011PC0453, and Proposal for a Regulation of the European Parliament and the Council on prudential requirements for credit institutions and investment firms COM (2011) 0452 final (Jul. 7, 2011). http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52011PC0452.

[15] *See* European Commission Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms COM (2012) 280 final (Jun. 6, 2012), http://eur-lex.europa.eu/%20LexUriServ/LexUriServ.do?uri=COM:2012:0280:FIN:EN:PDF.

[16] *See* European Commission Proposal for a Regulation of the European Parliament and the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms COM (2013) 0520 final (Jul. 10, 2013). http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52013PC0520:EN:NOT.

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Schemes (DGS) which amended Directive 94/19/EC.[17]

By shifting the focus of the discussion to the European Banking Authority (EBA), the Commission, on the one hand, confirmed its authority to act as a non-binding mediator for the regulatory harmonization of cross-border supervision and bank resolution in the European Union.[18] On the other hand, the proposed amendments to Regulation (EU) No. 1093/2013 would reinforce the powers and functions of the EBA with respect to the ECB. Coherently with this project, the regulation proposed a change in the voting mechanisms in order to prevent Members of the SSM-from holding a block majority in the EBA.[19]

The Regulation for the establishment of the SSM was repeatedly amended until its final approval by the European Council on October 15, 2013.[20] A few days later, the Council also amended the EBA by approving Regulation (EU) No. 1022/2013.[21]

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[17] *See* European Commission Proposal for a Directive of the European Parliament and the Council on Deposit Guarantee Schemes COM (2010) 0368 final (Jul. 12, 2010). http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52010PC0368. The Proposal provided shorter pay-out periods (that would be limited to seven working days) and funding arrangements, where the lack of common standards has allowed for diverging models of ex ante and ex post funding schemes. On DGS see FRANCESCA ARNABOLDI, DEPOSIT GUARANTEE SCHEMES: A EUROPEAN PERSPECTIVE (2014).

[18] *See* SSM Commission Proposal, *supra* note 12, art. 4(1)(3): "The ECB will carry out its tasks within in the framework of the European System of Financial Supervision and will closely cooperate with the three European supervisory Authorities. The EBA will keep its powers and tasks to further develop the single rulebook and ensure convergence and consistency of supervisory practice. The ECB will not take over any tasks of the EBA and the exercise of its regulatory powers in accordance with art. 132 of the TFEU will be limited to areas which are necessary for the proper exercise of the tasks conferred on the ECB by this regulation".

[19] *See* European Commission Proposal for a Regulation amending Regulation No. (EU) 1093/2010 establishing the European Banking Authority COM (2012) 512 final (Sep. 12, 2012).
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0512:FIN:IT:PDF.

[20] *See* Regulation 1024/2013 [hereinafter SSM Regulation or Regulation] of the European Parliament and of the Council of 15 October 2013, Conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, 2013O.J.(l.287),56(EU).http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:287:0063:0089: EN: PDF.

[21] *See* Regulation 1022/2013 [hereinafter EBA amended Regulation] of the European Parliament and of the Council of 22 October 2013, amending Regulation 1093/2010 and establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation 1024/2013, 2013 O.J. (L 287) 5. (Oct. 15, 2013), which is available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:287:0005:0014: EN: PDF.

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Regulation (EU) No. 575/2013 and Directive 2013/36/EU were later approved on June 26, 2013 with the intent to harmonize the legislation in the banking sector (CRR/CRD IV).[22]

After several delays, the Directives on deposit guarantee schemes and on the resolution of banks, have been approved on April 15, 2014.[23] Similarly, the Regulation for the establishment of a SRM has finally been adopted by

[22] *See* Memorandum from the European Comm'n on Capital Requirements (Jul. 16, 2013), http://europa.eu/rapid/press-release_MEMO-13-690_en.htm?locale=en. Among the main innovations, a special mention has to be made regarding the general strengthening of supervision (*e.g.* through supervisory plans, onsite inspections, more robust and intrusive supervisory assessments) and a harmonization of sanctions to ensure uniform application of Basel II and III by limiting national options and discretions. The CRR also tightens large exposure limits, liquidity ratios, and public disclosure requirements, and introduces an indicative leverage ratio. Ensuring full consistency of rules is a natural policy response to the high degree of financial and monetary integration in the European Union in general and in the euro area in particular. The CRR/CRD IV acknowledges that financial stability risks differ across jurisdictions and institutions, and provides national authorities with the flexibility to impose stricter standards to respond to macro-prudential concerns. In particular, Common Equity Tier 1 capital ratios can be increased by up to 3% (systemic risk buffer) on all exposures or up to 5% on domestic or non-EU exposures without the Commission's pre-approval. For higher buffers, pre-approval is required. Member States keep the power to impose temporarily (for up to two years, but extendable) some stricter prudential requirements for domestically licensed financial institutions. The Regulation maintains the national authorities' capacity to require Pillar 2 capital add-ons for individual institutions, based on their risk profile. The texts of Regulation (EU) 575/2013 [hereinafter CRR] of the European Parliament and of the Council of 26 June 2013, 2013 O.J, on prudential requirements for credit institutions and investment firms and amending Regulation (EU) 648/2012, and of Directive 2013/36/EU [hereinafter CRD IV] of the European Parliament and of the Council of 26 June 2013, 2013 O.J, on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC. See: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:IT:PDF; http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:IT:PDF.

[23] *See* Directive 2014/59/EU [hereinafter BRRD] of the European Parliament and of the Council of 15 April 2014, Establishing a framework for the recovery and resolution of credit institutions and investment firms, 2014 O.J. (173) 190 which is available at http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm and Directive 2014/49, of the European Parliament and of the Council of 16 April 2014, on Deposit Guarantee Schemes, 2014 O.J. (173) 149. available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0049&from=EN. Moreover, with respect to DGS on November 24, 2015 the European Commission published a Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme [hereinafter EDIS] COM (2015) 586 final (Nov. 24, 2015), http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52015PC0586. According to such Proposal the EDIS would be developed over time and in three stages. It would consist of a reinsurance of national DGS, moving after three years to a co-insurance scheme, in which the contribution of EDIS will progressively increase over time. As a final stage, a full European Deposit Insurance Scheme is envisaged in 2024. The scheme includes a series of strong safeguards against "moral hazard" and inappropriate use, in order to give incentives to national schemes to manage their potential risks in a prudent way. In particular, a national scheme will only be able to access EDIS if it fully complies with relevant Union law.

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the European Council on July 15, 2014.[24]

2. THE RATIONALE BEHIND A CENTRALIZED SUPERVISION

This paragraph is intended to illustrate the main reasons that have driven recent European regulatory reforms towards major centralization in banking supervision by focusing in particular on the position of cross-border banking groups. These credit institutions are usually integrated groups which operate through branches or subsidiaries. Subsidiaries are incorporated under the law of the jurisdiction in which they operate. By becoming legally separate entities as a result of the process of incorporation subsidiaries can benefit from the rules on limited liability. On the contrary, as branches are not legally separated from the parent company, they are subject to a regime of joint liability with the latter and share the same applicable laws.

Traditionally, the division of responsibility between the home country and the host jurisdiction depended on whether the bank operated through branches or subsidiaries.[25]

Moreover, notwithstanding the process of harmonization of the prudential regulation initiated by the European Union, diverging national implementations and supervisory practices have always generated

[24] *See* Regulation 806/2014 of the European Parliament and of the Council of 15 July 2014, Establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation 1093/2010, 2014 O.J. (225) 1, available at http://eurlex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.225.01.0001.01.ENG.

[25] In the European Union, mutual recognition and the single license allow a European financial institution to establish branches in other Member States under the prudential regulation and supervision of the home country. Subsidiaries, on the contrary, fall under the competence of their State of incorporation. However, the single license system has enjoyed limited success in practice as international banking groups often chose to establish subsidiaries rather than branches in other Member State. *See* Jean Dermine, *European Banking Integration: Don't put the cart before the horse*, 15 FIN. MKT., INSTITUTIONS & INSTRUMENTS 57 (2006), *see also* Guido Ferrarini & Filippo Chiodini, *Nationally Fragmented Supervision over Multinational Banks as a Source of Global Systemic Risk: a Critical Analysis of Recent EU Reforms*, *in* FINANCIAL REGULATION: A POST CRISIS ANALYSIS (Guido Ferrarini, Eddy Wymeersch & Klaus J. Hopt eds., 1st ed. 2012).

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substantial discrepancies.[26] As a result, cross-border banking groups were generally subject to nationally fragmented regulation and supervision.

In particular, the mismatch between the scope of cross-border groups and the national character of the supervision had a negative impact on crisis prevention and increased systemic risk. This was especially true in a political context in which the absence of credible agreements between governments on how to share the burden of crisis was a barrier to cross-border bank bailout. As a consequence, there was the considerable risk of spreading contagion to other banks. In addition, the belief that governments need to save insolvent banks has been a source of moral hazard for the management of the banks and for the behavior of shareholders and creditors. At the same time, the fact that some countries were not able (or simply did not want) to implement a bailout of troubled banks with public money created competition distortions by penalizing banks in countries with weaker economies (or smaller in terms of GDP).

It seems therefore evident that greater centralization in the supervision resolves at least part of these problems.[27] Indeed, the fragmentation between national regulations as well as the related systemic risk would be reduced if national regulators transfer some of their powers to a supranational body and Member States give up part of their sovereignty.[28] Therefore, it is not surprising to notice that the typical legislative response to

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[26] *See* Dirk Schoenmaker & Sander Oosterloo, *Cross-Border Issues in European Financial Supervision in* THE STRUCTURE OF FINANCIAL REGULATION (Davis Mayes and Geoffrey Wood eds., 2005); Eva Hüpkes, *Form Follows Function - A New Architecture for Regulating and Resolving Global Financial Institutions*, 10 EUR. BUS. ORG. L. REV. BOR. 369, 377 (2009).

[27] However, critics of centralization advocate "more national" solutions, in which national authorities would be better empowered to supervise regulated entities in view of safeguarding domestic financial stability. According to similar proposals, new powers would be attributed to host regulators, including the power to impose "subsidiarization" of foreign branches that are systemically significant in the host State; in other words, regulators would be entitled to treat these branches like subsidiaries for supervisory purposes. In addition, host authorities would be empowered to regulate cross-border financial operations on the basis of their potential effect on host economies (so-called "effect based regulation"). These enhanced powers would supposedly facilitate coordination and cooperation with home authorities. Host regulators would be in a position to "bargain" with home regulators, who would be incentivized to take the financial stability of host economies seriously into account. On this point see in particular KATARINA PISTOR, *Host's Dilemma: Rethinking EU Banking Regulation in Light of the Global Crisis* (European Corp. Governance Inst. – Fin. & Columbia Law Sch., Working Paper No. 286, 2010), http://www.ecgi.org/wp/wp_id.php?id=447.

[28] *See* Nicolas Veron, *The Economic Consequences of Banking Union in* EUROPEAN BANKING UNION (Guido Ferrarini & Danny Busch eds., 2015).

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the financial crisis is the introduction, or the enhancement, of forms of regulatory and supervisory centralization.[29]

In particular, a centralized approach to supervision can be achieved along three different routes: (i) cooperation and coordination between authorities in different Member States; (ii) lead home (or consolidating) supervisor;[30] (iii) supranational authority. These three models can be combined to form two-tier systems consisting of a national and a supranational level.[31]

Following the De Larosière Report on the reform of the European supervisory architecture, the legislation approved on 24 November 2010,[32] [33] represented a significant step towards regulatory convergence and centralization of cross-border supervision. The most recent regulatory framework indeed combines "enhanced" cooperation with elements of the other two models of centralization. In particular, the 2010 reform institutes a European System of Financial Supervision (ESFS). Firstly, it assigns the macro-prudential supervision to a newly established European Systemic Risk Board (ESRB). Secondly, a network of national supervisors, which re-employs pre-existing European Supervisory Committees and is subject to the coordination of the new European Supervisory Authorities (ESA), is

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[29] *See* David T. Llewellyn, *Role and Scope of Regulation and Supervision, in* HANDBOOK OF SAFEGUARDING GLOBAL FINANCIAL STABILITY: POLITICAL, SOCIAL, CULTURAL AND ECONOMIC THEORIES AND MODELS 451 (Gerard Caprio ed., 2013).

[30] The lead supervisor model consists of a single authority with supervisory powers over the whole cross-border group, irrespective of whether operating through branches or subsidiaries. It avoids duplication of regulatory requirements and reduces compliance and enforcement costs. The home authority is the lead supervisor, retaining responsibility for consolidated supervision over the banking group and its individual entities. A variant of this model keeps host authorities involved, so as to ensure supervisors' proximity to cross-border establishments and allow local conditions to be sufficiently taken into account.

[31] *See* Ferrarini & Chiodini, *supra* note 25, at 8, 10.

[32] The relevant legislation includes: Regulation (EU) 1092/2010 of the European Parliament and of the Council of 24 November 2010, Establishing the new ESRB in charge of macroprudential supervision, 2010 O.J. (L 331) 1; Regulation (EU) 1093/2010 [hereinafter EBA Regulation], of the European Parliament and of the Council of 24 November 2010, Establishing the EBA, 2010 O.J. (L 331) 12; Regulation (EU) 1094/2010 of the European Parliament and of the Council of 24 November 2010, 2010 O.J, establishing the European Insurance and Occupational Pensions Authority [hereinafter EIOPA], and Regulation (EU), 1095/2010 of the European Parliament and of the Council of 24 November 2010, 2010 O.J, Establishing the European Securities Markets Authority [hereinafter ESMA], in charge of microprudential supervision, respectively of the banking, insurance, and securities sectors, 2010 O.J. (L 331) 84. The Regulations are available, among others, on the website of the EBA at http://www.eba.europa.eu/.

[33] *See supra* note 13.

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appointed as micro-prudential supervisor.[34]

The creation of a centrally coordinated network was aimed at enhancing effective cooperation between competent authorities in the supervision of cross-border financial institutions, while leaving day-to-day supervision to national authorities.[35]

This architecture, however, as it represents the result of a political compromise, is ultimately a weak form of centralization which is based on cooperation among competent authorities.[36] As unquestionably proven by the recent financial crisis cooperation is doomed to fail in emergency situations because national supervisors tend to privilege domestic interests.[37]

The lack of a sufficiently consistent system to supervise the banking sector of Member States which became interdependent after the creation of a Monetary Union was highlighted by the simultaneous crisis of both credit institutions and sovereign debts. With the aim to restore confidence in the financial stability of Eurozone banks and to temper the connection between

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[34] The EBA, in particular, has been provided with the power to: (i) develop proposals for regulatory technical standards to be submitted to the European Commission, under EBA Regulation, *supra* note 32, art. 10 and 15, (ii) to adopt guidelines and recommendations addressed to national authorities or to financial institutions with a view to establishing consistent, efficient and effective supervisory practices, and to ensuring the common, uniform and consistent application of E.U. law (EBA Regulation, *supra* note 32, art. 16), (iii) to adopt, in emergency situations, acts in place of the national authorities in the event of a breach of E.U. law and to resolve disputes between competent authorities in cross-border situations (respectively pursuant to EBA Regulation, *supra* note 32, artt. 17, 19 and 19).

[35] *See* Marco Mancini, *Dalla vigilanza nazionale armonizzata alla banking union* [*From the Harmonized National Supervision to the Banking Union*], QUADERNI DI RICERCA GIURIDICA DELLA BANCA D'ITALIA, Sep. 2013, at 1 (It.). With the exception of the ESMA, which have been entrusted with the task of direct control over transnational bodies such as rating agencies and managers in post-trading facilities, and aside from the limited powers granted to EBA only in the cases set out in note 34, the European legislator merely attributed to the European Supervisory Authorities responsibilities for coordination of the national authorities, while leaving to them the exercise of direct supervision of intermediaries. *See also* EMILIOS AVGOULEAS & DOUGLAS W. ARNER, *The Eurozone Debt Crisis and the European Banking Union: A Cautionary tale of Failure and Reform* (Univ. of H. K. Faculty of Law, Working Paper No. 37, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2347937.

[36] *See*, for comments, F. Recine and P. G. Teixeira, '*Towards a New Regulatory Model for the Single European Financial Market*', 4 *Revue Trimestrielle de Droit Financier* (2009); Anders Neergaard, *European Supervisory Authorities–A New Model* for the *Exercise* of *Power* in the *European Union*?, 2009 EUREDIA 603; Guido Ferrarini & Filippo Chiodini, *Regulating Multinational Banks in Europe: An Assessment of the New Supervisory Framework*, 6 CURRENT DEVELOPMENTS IN MONETARY AND FIN. L. 93 (2012); Eilis Ferran, *Understanding the New Institutional Architecture of EU Financial Market Supervision in* FINANCIAL REGULATION: A POST CRISIS ANALYSIS (Guido Ferrarini, Klaus J. Hopt & Eddy Wymeersch eds., 2012).

[37] Voluntary cooperation and coordination mechanisms tend to fail when the financial stability and national taxpayers' money are at risk. Due to a problem of collective action, similar to that of the prisoner's dilemma, the national mandate and the consequent misalignment of incentives of supervisors prevent them to seek cooperative, although more efficient, solutions, by giving precedence to nationalistic and protectionist solutions. *See* Ferrarini & Chiodini, *supra* note 36.

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bank solvency and government debt, centralized banking supervision emerged as a necessary response to the crisis of the euro.[38] In practice, even though the need to rethink bank surveillance in Europe was often highlighted before the 2008 financial crisis, most countries, including euro countries, were reluctant to transfer additional sovereignty to European institutions in this crucial sector. After the 2011 sovereign debt crisis, national self-interest was however put aside and the idea of a centralized supervisory mechanism, also widely supported by scholars, became more broadly accepted.

Centralized supervision allows, *inter alia,* to mitigate national interest concerns which, in the past, have been responsible for deteriorating public finances. Indeed, in some instances, domestic authorities have turned a blind eye to the accumulation of considerable imbalances in the balance sheets of credit institutions with the intent to promote national champions.

In this scenario of sovereign debt crisis, the European Commission published a draft Regulation which conferred supervisory tasks on the ECB, which was intended to represent a milestone in the establishment of a single supervisory mechanism in the Eurozone as the central pillar of the banking union.

The ECB was therefore given a clear mandate and broad powers to supervise all Eurozone banks. As the ECB was endowed with extensive internal expertize in the areas of both macroeconomics and financial stabilization, it was well-equipped to conduct supervisory tasks with the purpose of preserving the stability of the European financial system.

[38] *See* Gianni Lo Schiavo, *From National Banking Supervision to a Centralized Model of Prudential Supervision in Europe*, 21 MAASTRICHT J. EUR. & COMP. L. 110 (2014).

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Indeed, the establishment of a new agency would have required the revision of the Treaty.[39]

Major forms of centralization in banking supervision in the Eurozone was also interpreted as a pre-condition to the establishment of a jointly-funded common mechanism for the resolution of crises in the banking sector and the prevention of growing moral hazard.

The SSM entered into force on November 4, 2014.[40] Therefore, the SSM essentially belongs to the third model of centralization - single supervisor - described above. The following paragraphs illustrate the functioning of the single supervisory mechanism, the role of the EBC within it, its impact on the supervision of cross-border banking groups and its potential weaknesses.

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[39] *See* Francesco Guarracino, *Il Meccanismo Unico di Vigilanza sugli Enti Creditizi tra Diritto Primario e Riforma dei Trattati,* 2013 RIVISTA TRIMESTRALE DI DIRITTO DELL'ECONOMIA 171 (It.) and CONCETTA BRESCIA MORRA, *From the Single Supervisory Mechanism to the Banking Union: The Role of the ECB and the EBA (*Luiss Guido Carli Sch. of European Political Econ., Working Paper No. 2, 2014), http://sep.luiss.it/sites/sep.luiss.it/files/WP%20SEP%20C.%20Brescia%20Morra%20def.pdf. According to the "Meroni doctrine", in fact, tasks that involve the exercise of discretionary powers cannot be assigned to newly established bodies not provided by the Treaties. In particular, the term "Meroni Doctrine" refers to the position taken by the European Court of Justice in its judgment of 13 June, 1958, Case 9/56, *Meroni & C. v. High Authority*, ECLI:EU:C:1958:7, where the CJEU considered the delegation of power - by the European Union institutions to external bodies - to be unlawful if the delegation includes so much "freedom" to take the form of a real discretion. However, in January 2014 the CJEU (Case C-270/12, *United Kingdom v. Parliament and Council,* ECLI:EU:C:2014:18) has delivered a decision that repositions the extent to which European institution can organize separate bodies to whom part of their own decision making power can be transferred. In particular, in a case opposing the United Kingdom to the European Council and Parliament involving the powers of ESMA to directly prohibit short selling in certain circumstances, the Court held that this conferral of powers did not infringe the "Meroni rule", that only prohibits to delegate a wide margin of discretion. The Court analysis based its finding on the existence of strict objective criteria in the contested provision in the Short Selling Regulation, and the fact that its decisions are amenable to judicial review. The ESMA judgment does not reject the "Meroni doctrine" outright but it attenuates its impact by making it clear that the test for the legality of the conferral of discretion on an agency is a nuanced one: provided there are conditions and criteria to limit the discretion, and the power is precisely delineated so as to be amenable to judicial review, the requirements laid down in the "Meroni rule" are satisfied. *See* JACQUES PELKMANS & MARTA SIMONCINI, *Mellowing Meroni: Hows ESMA can help build the Single Market*, CEPS.EU (Feb. 18, 2014), http://www.ceps.be/book/mellowing-meroni-how-esma-can-help-build-single-market. On this point see also LORENZO CUOCOLO, *Constitutional Issues of the Banking Union, between European Law and National Legal Orders* (Baffi Carefin Ctr., Working Paper, No. 10, 2015).

[40] *See* Francesco Ciraolo, *Il Regolamento UE n. 1024/2013 sul Meccanismo Unico di Vigilanza e l'Unione bancaria Europea. Prime riflessioni* (2014) [*EU Regulation No. 1024/2013 Regarding the Single Supervisory Mechanism and the European Banking Union*] , http://www.amministrazioneincammino.luiss.it/app/uploads/2014/07/Ciraolo_Unione-bancaria.pdf; Klaus Lackhoff, *How will the Single Supervisory Mechanism (SSM) Function? A brief overview*, 29 J. INT'L. BANK. L. & REG. 498. (2014); CHRISTOS V. GORTSOS, THE SINGLE SUPERVISORY MECHANISM (SSM): LEGAL ASPECTS OF THE FIRST PILLAR OF THE EUROPEAN BANKING UNION (2015).

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3. THE SINGLE SUPERVISORY MECHANISM (SSM). SCOPE, DIVISION OF TASKS AND COOPERATION WITHIN THE SSM

The single supervisory mechanism is composed by the ECB and by the national competent authorities.[41] The European Central Bank is appointed as central prudential supervisor of financial institutions in the euro area. Given that the ECB is responsible for its effective and consistent functioning, this model aims at more than enhanced cooperation.

While the SSM covers all credit institutions which are established in the Eurozone, most of the less significant supervisory tasks are normally carried out by national authorities under a two-tier regime.[42] Indeed, the criteria to determine whether banks fall under the direct supervision of the ECB include the bank's size, its importance for the economy of the European Union, as well as for the economy of the Member State, and the extent of its cross-border activities.[43]

More specifically, in order to fall under the direct supervision of the ECB one of the following conditions needs to be met: (i) the assets of the bank exceed 30 billion euros, (ii) the *ratio* of its total assets to the GDP of its Country of establishment is above 20%, or (iii) the competent national authorities define the institution as significant. The ECB, however, retains the power to bring any bank under its direct supervision, when necessity so requires.[44] For example, the ECB may consider an institution as significant if it has substantial cross-border assets or liabilities, if it relies upon the ESM

[41] For an in-depth analysis of the respective competences of the ECB and the national authorities see Raffaele D'Ambrosio, *The ECB and NCA liability within the Single Supervisory Mechanism*, 78 QUADERNI DI RICERCA GIURIDICA DELLA BANCA D'ITALIA 1 (2015); *see also* E. WYMEERSCH, *The single supervisory mechanism or "SSM", part one of the Banking Union* (Nat'l Bank Of Belg., Working Paper No. 255, 2014), https://www.nbb.be/doc/ts/publications/wp/wp255en.pdf. *See also* EUROPEAN CENT. BANK, *Guide to banking supervision*, ECB.EUROPA.EU (Nov., 2014), https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguidebankingsupervision201411.en.pdf.

[42] The Regulation is without prejudice to the responsibilities and related powers of the competent authorities of the participating Member States to carry out supervisory tasks not conferred to the ECB. *See* SSM Regulation, *supra* note 20, art. 1.

[43] *See* SSM Regulation, *supra* note 20, art. 6(4).

[44] According to the SSM Regulation, *supra* note 20, art. 6(4), the ECB may also, on its own initiative, consider an institution to be of significant relevance where it has established banking subsidiaries in more than one participating Member States and its cross-border assets or liabilities represent a significant part of its total assets or liabilities.

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for financial assistance, or if it is one of the three largest institutions in its Country of establishment. The ECB is therefore able to exercise direct supervision on the largest banks in smaller countries. According to these criteria, banks that fall under the direct supervision of the ECB account for about the 80% of the aggregate banking assets of the euro area.[45]

The SSM's prudential supervision[46] applies to banks or, more precisely, "credit institutions", which are defined as an undertaking whose business is to "receive deposits or other repayable funds from the public and to grant credits for its own account".[47]

Institutions that national laws may define as "banks" even if they do not receive deposits, would therefore be excluded from the SSM as they do not qualify as banks under E.U. law.[48] The European definition of "credit institution" prevails as otherwise Member States would be able to determine the scope of the SSM.[49]

Several categories of financial institutions that do not formally qualify as banks are therefore not subject to the SSM. This may result surprising as some of these institutions are clearly significant, and may even be systemically relevant.

However, even though non-banking activities remain supervised nationally, they are not entirely excluded from the supervision of the SSM. These activities will often have a direct impact on the risk profile of the banking group and, therefore, they will also fall within the orbit of the banking supervisor.[50]

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[45] *See* Klaus Lackhoff, *Which Credit Institutions will be supervised by the Single Supervisory Mechanism?*, 28 J. INT'L. BANK. L. & REG. 454 (2014); G.B.WOLFF & C. DE SOUSA, *A banking union of 180 or 81%?*, BRUEGEL.ORG (Dec. 14, 2012), www.bruegel.org/nc/blog/detail/article/965-a-abanking-union- of-180-91- percent.USX4lh03hWI.

[46] On the scope of the SSM see E. Wymeersch, *The Single Supervisory Mechanism for Banking Supervision: Institutional Aspects in* EUROPEAN BANKING UNION (Danny Busch & Guido Ferrarini eds, 2015).

[47] *See* SSM Regulation, *supra* note 20, art. 2(3).

[48] According to French law, specialized financing institutions - leasing, factoring and similar - are subject to prudential supervision, without receiving deposits from the public. For the list see www.acp.banque-france.fr/controle-prudentiel/les-assujettis- au-controle.html.

[49] *See* WYMEERSCH, *supra* note 41, at 27.

[50] *See* WYMEERSCH, *supra* note 41, at 28.

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In this respect, art. 127 (6) of the TFEU would allow "other financial institutions", with the exception of insurance undertakings, to be included in the SSM's remit.[51]

However, while insurance firms have been expressly excluded, the increasing similarities between banking and insurance supervision and the recognition of their systemic significance[52] will, sooner or later, lead to the introduction of a more integrated form of supervision for insurance firms.[53]

The Regulation conferred to the ECB the following tasks when dividing the duties within the SSM between the ECB and national authorities: to authorize credit institutions and withdraw their authorizations; to assess applications for the acquisition and disposal of qualifying holdings in credit institutions; to ensure compliance of credit institutions with prudential requirements (e.g. own funds requirements, large exposure limits, liquidity, leverage, etc.) as well as governance arrangements ("fit and proper" management, risk management processes, internal control mechanisms, remuneration policies, etc.); and finally, to carry out supervisory reviews, including stress tests and other supervisory tasks such as, for instance, recovery and early intervention plans.[54]

On the other hand, by looking at the tasks which are conferred upon the ECB by art. 4, competent national authorities carry out, and are responsible for, all relevant supervisory decisions in accordance with art. 6 (7). They also have to regularly report to the ECB on the performance of their supervisory activities. They are also exclusively responsible for consumer protection and anti-money-laundering tasks, for receiving notifications from credit institutions in relation to the right of establishment, for supervising

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[51] *See* Consolidated Version of the Treaty on the Functioning of the European Union art. 127(6) Jun. 7, 2016, 2016 O.J. (C 202) 47 [hereinafter TFEU].

[52] *See* INT'L ASS'N OF INS. SUPERVISORS, *Consultation on G-SIIs, Global Systemically Important Insurers: Proposed Policy Measures*, IAISWEB.ORG (Oct., 2015), http://www.iaisweb.org/index.cfm?pageID=988&lyrHighlightWord=systemic%20&searchvalue=systemic; Jaime Caruana, Gen. Manager, Bank for the Int'l Settlements, *Insurance and financial stability: a Basel view* (Mar. 20, 2013), http://www.bis.org/speeches/sp130408.htm; PwC, '*The supervision of global systemically important insurers - G-SII*', (Jul., 2013), http://www.genevaassociation.org/portals/0/Geneva_Association_Systemic_risk_in_Insurance_Report_March20 10.pdf.

[53] *See* WYMEERSCH, *supra* note 41, at 27.

[54] *See* SSM Regulation, *supra* note 20, art. 4(1).

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the activities of branches of credit institutions from third countries as well as payment services.[55]

The Regulation pays ample attention to the functioning of the SSM as a cooperative mechanism. The ECB and the competent national authorities must cooperate in good faith cooperation and have an obligation to exchange information.[56] Additionally, national authorities are responsible for assisting the ECB with the preparation and implementation of acts in connection with the tasks conferred to the ECB by the Regulation.[57]

In particular, according to art. 6 (5) and (6) the ECB and national authorities share responsibility for the exercise of regulatory oversight on credit institutions which are only indirectly supervised by the ECB. Competent national authorities shall perform these supervisory tasks in conformity with the regulations, guidelines and general instructions issued by the ECB. When necessary to ensure the consistent application of high supervisory standards the ECB may decide to exercise its powers directly in relation to one, or more, credit institutions. Moreover, as the ECB oversees the functioning of the system, it may, at any time, exercise its investigatory powers and request information from the competent national authorities on the performance of the tasks that fall within their purview.

This kind of cooperation between the ECB and competent national authorities is, however, innovative with respect to previous experiences. Whereas the old model is generally horizontal, with supervisory authorities standing at the same level, in the SSM cooperation is vertical so as to ensure the overall functioning of the SSM under the leadership of the ECB.[58]

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[55] *See* SSM Regulation, *supra* note 20, pmbl. 28.
[56] *See* SSM Regulation, *supra* note 20, art. 6(2), referring probably to TFEU, *supra* note 51, art. 4(3), stating: "Pursuant to the principle of sincere cooperation, the Union and the Member States shall, in full mutual respect, assist each other in carrying out tasks, which flow from the Treaties".
[57] *See* SSM Regulation, *supra* note 20, art. 6(3).
[58] *See* WYMEERSCH, *supra* note 41, at 41.

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This cooperation has been further refined in the Framework Regulation for the SSM,[59] an instrument developed by the ECB in consultation with national authorities.[60] The Framework Regulation develops and illustrates cooperation procedures between the ECB and competent national authorities within the SSM as specified by the SSM Regulation itself. This document is particularly important as it coordinates and defines the relationship between the two levels of supervision. In particular, The Framework Regulation illustrates three main aspects: the methodology for determining the quantitative criteria for classifying banks as significant, or less significant, with special attention to changes in the regime;[61] arrangements with respect to the exercise of powers by both national supervisors and the ECB; procedures governing the relation between the ECB and national supervisors for the supervision of significant, as well as less significant, banks. The ECB has to be informed by national authorities about their concrete supervisory procedures in relation to less significant credit institutions (*e.g.* administrative or disciplinary measures, including sanctions and their implementation). The ECB can request further information and impose additional supervisory duties. Before the national supervisor adopts its final decision, it must obtain the opinion of the ECB, which does not, however, amount to a binding approval.

On the other side, the Framework Regulation establishes Joint Supervisory Teams (JSTs) for the supervision of significant banks. Every significant institution will have one team made up of personnel from both the ECB and competent national authorities. The team will be coordinated by a member of the ECB who, as a rule, will not have the same nationality of the supervised institution. The effectiveness of day-to-day supervision, however, largely depend on the support from the regulator of the State of

[59] *See* Regulation 468/2014 [hereinafter SSM Framework Regulation] of the European Central Bank of 16 April 2014, Establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities, 2014 O. (L 141) 1
http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0468.

[60] *See* SSM Regulation, *supra* note 20, art. 6 (7) (b) (iii).

[61] In accordance with the SSM Framework Regulation, *supra* note 59, art. 49(1), the ECB published a list containing the name of each entity and group directly supervised by the ECB and the list of entities supervised by a national competent authority as of December 30, 2015. The significant entities directly supervised by the ECB amount at 129. The list is available at
https://www.bankingsupervision.europa.eu/ecb/pub/pdf/list_for_publishing_20151230en.pdf.

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establishment. Indeed, whilst leading the supervisory activities, the ECB still has to utilize the local knowledge and the expertise of national authorities.

From this perspective, a potential limit of this regulatory setting is the extensive reliance on cooperation among supervisors as well as the delegation of supervisory functions to national authorities. The SSM, despite the strong powers conferred to the ECB, largely functions by delegating supervisory tasks to national authorities and by relying on their cooperation. The duties of cooperation and exchange of information[62] should prevent, or at least mitigate, information asymmetries between the periphery and the center of the SSM. The responsibility of the ECB for the system, together with the powers of direction and substitution with respect to national supervisors, lead to the conclusion that this model does not simply provide for enhanced cooperation.

In other words, the hierarchical structure of the SSM should solve problems of coordination between authorities, as well as information asymmetries which might otherwise advantage national authorities because of the apical position of the ECB. Information asymmetries can, however, be exploited, especially in times of crisis, to protect local and particular interests from the scrutiny of the ECB. National authorities may, for example, delay the transmission of important information to the ECB or procrastinate actions against national banks that are under their direct supervision regardless of the European interest to financial stability.

The recourse to this multifaceted architecture – based on cooperation and delegation under the direction and control of a central authority – was, to some extent, unavoidable. Indeed, out of more than 6,000 banks which are established in the Eurozone the top 150 institutions count for the 80% of banking assets.[63] Limited resources, political expediency, the existence in the Eurozone of different legal, accounting and taxation frameworks, as well as the coexistence of many languages and business backgrounds were all

[62] *See* SSM Regulation, *supra* note 20, art. 6(1) and (2).
[63] *See* IMF, *Staff Discussion Notes A banking union for the euro area* (Feb. 13, 2013), https://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf.

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relevant factors in deciding to lean on national authorities.[64] Full centralization was not an option even with regard to banks which operate transnationally: resources are mainly national and successful supervision still depends on the proximity of the banking institutions. Decentralization to domestic supervisors should not, however, mean that the central supervisor is merely validating decisions taken locally. Supervision is to be consistent throughout the Eurozone.[65]

As highlighted above, the SSM Framework Regulation tries to balance centralization and delegation by taking into account the size of banks as well as their national, or transnational, nature.[66]

Delegation, in fact, is a better solution for domestic institutions, even if the ECB is empowered to instruct national authorities and also to replace them in the supervision of one or more institutions.[67] Delegation mechanisms are, however, also in place for transnational banks, even though the ECB still exercises a stronger control.

On the other hand, cooperation mechanisms tend to fail in the event of a crisis. Rather than acting from a European perspective, supervisors tend to pursue their national interest. Delegation, indeed, inherently suffers from information asymmetries which allows the delegated authority to exploit information advantages. Duties to cooperate and share information are insufficient to compensate for similar imbalances, as national supervisors are often incentivized to disregard them, particularly when approaching a crisis. Moreover, the the ECB's powers to direct and substitute, which aim at preventing failures in the supervisory system, may be impaired by the non-cooperation of local supervisors, including non-compliance with their duty to share relevant information.[68]

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[64] *See* TOBIAS H. TRÖGER, *The Single Supervisory Mechanism – Panacea or Quack banking Regulation?* (Inst. For Monetary and Fin. Stability, Working Paper No. 73, 2013), http://www.imfs-frankfurt.de/fileadmin/user_upload/pdf/WP_73.pdf.
[65] *See* IMF, *supra* note 63.
[66] *See* SSM Framework Regulation, *supra* note 59.
[67] *See* SSM Regulation, *supra* note 20, art. 6(5).
[68] *See* G.FERRARINI, *Single Supervision and the Governance of Banking Markets* (European Corp. Governance Inst. – Law, Working Paper No. 294, 2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2604074&download.

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4. NON PARTICIPATING MEMBER STATES. THE OPT-IN REGIME

As highlighted, the SSM essentially applies to Member States within the euro area. The Regulation, however, allows Member States from outside the Eurozone to adhere to the SSM by entering a "close cooperation scheme" on a "contractual" basis. Adhesion requires the drafting of a Memorandum of Understanding.[69]In particular, States from outside the euro area must declare their adhesion to the SSM along with the commitment of their national authorities to respect the guidelines and comply with the requests of the ECB by furnishing all necessary information. These declarations are rendered by simultaneously notifying a request to other Member States, to the Commission, to the ECB and to the EBA.[70]

E.U. Member States that opt into the SSM are treated as States of the Eurozone, with the exception of a few aspects mentioned below.

Prudential supervision will be exercised according to the rules of the SSM and all banks established in the requesting Member State will be subject to the SSM regime. The abovementioned two-tier mechanism of the SSM would then equally apply.[71] Only the most significant banks are going to be supervised by the ECB which will then instruct national supervisors according to the protocol for banks in tier-one. Less significant institutions would remain under national supervision.[72]

The Treaty provides viable legal foundations for making the ECB the central supervisor for the Eurozone.[73] It does not, however, provide legal underpinnings for fully including countries from outside the Eurozone within the ECB's supervisory scope. In particular, the Treaty stipulates that non-Eurozone countries are not allowed to vote in the final decision-making body of the ECB. Similarly, non-Eurozone countries are not bound by the

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[69] *See* SSM Regulation, *supra* note 20, art. 7.
[70] However, technically, admission to the SSM is a unilateral decisions of the ECB under art. 7 (2) (a) of the SSM Regulation, *supra* note 20, art. 7(2)(a).
[71] *See* SSM Regulation, *supra* note 20, art. 7(2)(a) referring to artt. 5 and 6. As a consequence the entire two tier system, with significant and less significant banks becomes applicable and is notified to all Member States, whether or not belonging to the SSM.
[72] *See* SSM Regulation, *supra* note 20, art. 7(2)(a) referring to art. 6, meaning that the distinction between significant and less significant banks also apply here.
[73] *See* TFEU, *supra* note 51.

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deliberations of the ECB.[74] As a consequence, Member States from outside the Eurozone cannot become full members of the banking union as they do not enjoy the same rights and obligations as Eurozone countries. Whereas they can be full members of the Supervisory Board, only a change of the Treaty could allow them to become members of the Governing Council.[75] On this point, a few mitigating instruments have been implemented such as, for instance, the right to send an observer to the Governing Council.[76]

As a consequence, even when a non-Eurozone State has entered the SSM, the ECB is not allowed to take a decision that directly applies to a bank of that country.[77] The ECB has to communicate its decisions to the national supervisor, which will then ensure the bank's compliance. On the other hand, banks which are established in the Eurozone receive direct instructions from the ECB. "Close cooperation" agreements have a duration of at least three years. The loss of sovereignty which is inherent to this supervisory regime only allows to make provisional arrangements. Whereas States from the Eurozone do not have an option to leave the SSM as their adhesion is a consequence of their membership, States from outside the Eurozone could leave the SSM if the regime is no longer beneficial to them or if they disagree with its development. This clause has been drafted in order to safeguard sovereignty.[78] When the three years period expires, due to the voluntary nature of the close cooperation agreement, as well as to the ECB's inability to enforce supervisory decisions outside the Eurozone, the agreement can be terminated any time. The ECB and the participating third State can both terminate the agreement.[79] Termination would typically be the result of a disagreement on a supervisory decision.

On the one side, the ECB has two options to terminate. Firstly, the ECB can issue a warning to a State in which it declares that the State does not respect one of the aforementioned conditions. After the warning if sufficient

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[74] *See* TFEU, *supra* note 51, art. 139(1)(b).
[75] *See* TFEU, *supra* note 51, art. 139(1)(b).
[76] *See* SSM Regulation, *supra* note 20, pmbl. 43. The Governing Council and the Supervisory Board are the governing bodies of the SSM. On their composition and tasks see below the relevant paragraph.
[77] *See* SSM Regulation, *supra* note 20, art. 7 (4).
[78] *See* SSM Regulation, *supra* note 20, art. 7(5).
[79] *See* SSM Regulation, *supra* note 20, artt. 7(8) and 26(8).

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actions to stop the breach are not implemented, the ECB can terminate the close cooperation agreement. Secondly, if the Governing Council objects to a decision by the Supervisory Board, the State can then notify the Governing Council that it objects to the resolution of the Supervisory Board, as amended following the objection of the Governing Council. If the latter maintains its decision nonetheless, the State can choose whether to apply the supervisory decision. The Governing Council has then to evaluate the impact of the State's failure to implement the decision and decide whether to suspend or terminate the close cooperation agreement.[80]

On the other side, States from outside the Eurozone are given more options to terminate. A State can terminate the close cooperation agreement whenever it disagrees on a draft decision by the Supervisory Board. Moreover, if a State has been part of the SSM for more than three years its termination does not require any specific motivation. In the event of termination, the terminating State is not allowed to send a new proposal of close cooperation for the following three years.[81] This last provision[82] is intended to deter a State from interrupting the close cooperation agreement, by imposing costs of leaving the system[83], with the sole purpose of avoiding a decision of the Supervisory Board.[84]

The flexibility of the close cooperation agreement was inspired by the desire to include non-Eurozone States in the SSM. As a consequence, the final Regulation is more accommodating than the original SSM Commission Proposal. Too much flexibility can, however, undermine the ECB's supervisory authority as non-Eurozone States could at any point threaten not to apply a supervisory decision, or even leave the SSM altogether.[85]

The opt-in regime aimed at alleviating the evident shortcomings of a supervisory system that covers only part of the European Union. It is however doubtful whether States from outside the Eurozone have interest to

[80] *See* SSM Regulation, *supra* note 20, art. 7(7).
[81] *See* SSM Regulation, *supra* note 20, art. 7(9).
[82] *See* SSM Regulation, *supra* note 20, art. 7(9).
[83] *See* WYMEERSCH, *supra* note 41, at 63.
[84] *See* WYMEERSCH, *supra* note 41, at 63.
[85] On this point *see* STIJN VERHELST, *Assessing the single supervisory mechanism: passing the point of no return for Europe's banking union* (Egmont, Working Paper No. 58, 2013),http://www.egmontinstitute.be/wp-content/uploads/2013/07/Egmont-papers-58.pdf.

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enter the SSM. Reputational advantages, cost saving, as well as an overall simplification of the regulatory regime, may be contributing factors in attracting banking groups with large activities within the SSM jurisdiction. Ideally, after some time, markets will prefer a solid supervisory regime under the leadership of the ECB whose actions are not skewed by national interests. This choice will then lead to more favorable interest rates, credit ratings and equity prices. By obeying to a single supervisory regime these groups will benefit from uniform regulations and, therefore, they will all stand on the same footing in terms of supervisory standards. However, only "significant" groups would enjoy such benefit. Hence, the structure of the national banking systems will be a key factor in deciding whether to adhere to the SSM. Even States without major banking groups but with a considerable presence of branches and subsidiaries might prefer to reduce their involvement in prudential matters, as well as the costs of supervision, by adhering to the SSM. In addition, the adhesion to the single supervisory regime may have a beneficial effect on the credit rating of adhering States, especially in the run-up to joining the Monetary Union. By contrast, this regime entails a relevant loss of sovereignty and, therefore, the advantages of joining the regime are not so evident, not only for less significant banking groups.[86]

5. THE IMPACT OF THE SSM ON THE SUPERVISION OF TRANSNATIONAL BANKING GROUPS

The impact of the SSM Regime on transnational banking groups deserves a specific analysis, which, for the purposes of this paper, will be confined to the attribution of key supervisory competences.

First of all, the ECB exercises direct supervision on all activities in the Eurozone of the branches of significant banking groups whose headquarters are located in States which are under the supervision of the SSM. In particular, when a branch qualifies for direct ECB supervision (which is to be determined according to the abovementioned criteria) the whole group falls

[86] On the reasons to opt-in see WYMEERSCH, *supra* note 41, at 61.

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under the supervision of the ECB. In this respect, the SSM regime is merely applying the "home country rule" where the home supervisor, whose functions have now been transferred to the ECB, is fully in charge of both home and host activities. Additionally, the same principle will apply to branches which operate in non-participating States. The ECB, indeed, maintains identical supervisory functions with respect to significant banking groups which, though under the supervision of the SSM, have established branches in non-participating States.[87]

Secondly, subsidiaries of significant banking groups that qualify for ECB's direct supervision are also directly supervised by the ECB regardless of their individual importance. As anticipated, since the assessment is done on a consolidated basis, national supervisors would not, therefore, maintain any direct supervisory competence.[88] Subsidiaries of banking groups that do not fall under the ECB's remit continue to be supervised nationally by the supervisors of the host country.

There are some significant consequences which stem from this new regime.[89] For instance, in term of prudential supervision differences between branches and subsidiaries are likely to disappear.[90] With respect to supervisory activities, differences in banking operations, regardless of whether they involve branches or subsidiaries, will in some respects become less relevant. As a consequence, it may become more profitable to exercise the activity through branches, as this would avoid the additional requirements of having to manage separate entities (e.g. own capital requirements, separate liquidity, management, boards, auditors, different regulators, etc.).[91] On the other hand, other aspects, such as for instance

[87] *See* SSM Regulation, *supra* note 20, art. 4(1)(b). But this obviously only refers to banking groups under the ECB's direct supervision, as this task is placed within the framework of SSM Regulation, *supra* note 20, art. 6(6).
[88] *See* SSM Regulation, *supra* note 20, art. 9(1).
[89] For an overview of the consequences of the SSM on the supervision of cross-border banking groups see E. WYMEERSCH, *supra* note 41, at 32-37.
[90] Indeed, underlying banking law may still contain some differences that the ECB will have to respect. Other factors may continue to play an important role in decisions as to where additional operations will be established.
[91] *See* WYMEERSCH, *supra* note 41, at 34.

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taxation, labor law, minority shareholders rights and local culture might, however, still be relevant in deciding whether to maintain a subsidiary.[92]

Less significant groups continue to be governed by the previous scheme: while branches fall under the purview of the home supervisor, the host supervisor is competent to supervise subsidiaries. Medium sized groups, that are active in several E.U. States, are now subject to a multitude of supervisors. For these institutions this regime is likely to be quite burdensome: all their activities, regardless of whether they are located in participating or in non-participating States, will have to deal with a fragmented supervisory landscape. An adequate response might be to convert the subsidiary into a branch so as to trigger a uniform, though national, supervisory regime. The structure of medium sized groups is relevant in determining whether the ECB might be able to retain competence. The ECB, indeed, in the presence of considerable cross border activities, and when the network of subsidiaries is significant, can decide to supervise them as tier one banking groups.[93] On the basis of the abovementioned criteria, only the ECB is, however, entitled to decide whether to exercise direct supervision on a credit institution. Indeed, according to the SSM regime cross-border banking groups are not offered an "opt-in option".[94]

With respect to participating States from outside the Eurozone, the rules to determine supervisory competence remain unchanged. Whether the ECB will be able to retain competence over national supervisors depends on the abovementioned criteria. The parent company's consolidated data will be utilized to determine the applicable supervisory regime.

A comparable national regime is applicable to less significant groups where the supervision is exercised by the national supervisors of the home State for the parent company and its branches. Subsidiaries, on the other hand, fall within the purview of the host State.

[92] *Cf.* SSM Regulation, *supra* note 20, art .1(5).
[93] The Regulation mentions the ECB competence only with respect to subsidiaries but the assessment on a consolidated basis should prevail and therefore also the branches of the parent should be included in this calculation.
[94] *See* WYMEERSCH, *supra* note 41. at 34.

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The basic regime, as laid down in the Directives, then continues to apply to branches of banks which are established in non-participating States. The home supervisor of the State where the subsidiary is located will be the competent supervisory authority for their subsidiaries in the SSM area. The ECB will not be involved, even when banking groups cross the abovementioned consolidated quantitative thresholds.[95]

When quantitative thresholds are met exclusively by subsidiaries (on sub-consolidated basis) the ECB would be the competent supervisory authority as the subsidiary is a separate legal entity which is established in the SSM area. Under these circumstances, the ECB and the home supervisor of this group would have to conclude a Memorandum of Understanding (MOU) so as to define their respective positions in the college of supervisors.[96]

Even within the SSM area, the SSM Regulation approaches differently branches whose banking groups are established in a non-participating State. According to the relevant Directives, whereas the home supervisor is normally competent, the host supervisor has limited intervening powers.[97] In accordance with the SSM Regulation, "the ECB shall carry out the tasks for which the national authorities are competent in accordance with relevant Union law".[98] Therefore, all branches, regardless of their importance or volume, will be supervised by the ECB and in accordance ECB standards. Vice versa, according to E.U. law, when banking groups that fall within the purview of the SSM establish branches in non-participating States, these branches fall under the home competence of the ECB.[99]

On the basis of the rules on consolidated supervision, the local supervisor is competent to supervise subsidiaries of banking groups within the Eurozone even if they are located in a non-participating State.

[95] *See* WYMEERSCH, *supra* note 41, at 35.
[96] *See* SSM Regulation, *supra* note 20, art. 3(6), makes this mandatory for States housing the systemically important institutions. For the other non-participating States, a MOU in general terms will be concluded: *see* SSM Regulation, *supra* note 20, pmbl. 14.
[97] *See* CRD IV, *supra* note 22, artt. 40 ss; *see also* the regime for the significant branches set out in CRD IV, *supra* note 22, art. 51.
[98] *See* SSM Regulation, *supra* note 20, art. 4(2), irrespective whether there will be one or several branches. By incorporating one of these, supervision may shift to the national level, provided this group is "non-significant".
[99] *See* SSM Regulation, *supra* note 20, art. 4(1)(b), applying general Directive principles.

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Coordination among competent supervisors follows the existing E.U. Directives and supervisory coordination rules within colleges of supervisors for deciding between home and host supervisors. Therefore, if the headquarter of a significant banking group is located in the Eurozone, the ECB will be the leading supervisor, and the supervisory college will include supervisors from the non-participating jurisdictions where the subsidiaries are located. Vice versa, where a subsidiary in the euro area is part of a banking group whose place of establishment is in a non-participating jurisdiction, the supervisors of the States where these subsidiaries are located will normally join and lead the supervisory college, while the ECB is merely invited as a member. When a subsidiary is crossing the thresholds, the consolidated supervisor that is in charge of the group will not participate and the ECB will be in charge of the subsidiaries within the Eurozone.

Finally, with respect to banking groups in third countries' jurisdictions, the SSM Regulation remains largely silent.[100] Their subsidiaries and branches are therefore subject to the national supervisor of their place of establishment within the European Union and the regime of that jurisdiction will apply. This would mean that these groups could continue to operate under a regime of freedom to provide services while their subsidiaries would be subject to the supervision of national authorities on capital, management and all other aspects of banking regulation. Only if significant subsidiaries are subject to the supervision of the ECB. As mentioned above, the regime subjecting branches to direct ECB supervision [101] is only applicable to activities of groups established in non-participating States, but it does not apply to third country groups. From the perspective of systemic protection this difference could be justified: protection is merely offered to creditors of banks which are in the Eurozone. It may, however, create unfair advantages

[100] SSM Regulation, *supra* note 20, pmbl. 28, reminds that their supervision remains a national matter. With third countries, international agreements could be concluded by the ECB (pmbl. 80), but respecting the competences of the E.U. institutions, of the EBA and of the Member States. The European Union banks have to be considered third country banks.

[101] *See* SSM Regulation, *supra* note 20, art. 4(2). Host supervision for branches and services has been redefined and extended in CRD IV, *supra* note 22: if branches are not subject to host authorization (art. 17), there has to be close cooperation on a broad range of issues for both supervisors of branches (artt. 51 - 53). The host can request a branch to be qualified significant (art. 52) in which case special supervision is needed on liquidity and risks. Inspection for financial stability reasons are initiated by the host, although action from the home is expected (art. 53).

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for banks which are established in third countries. In this case, the national supervisory regime would be competing with the SSM.[102]

In conclusion, the effects of the SSM regime on the legal position of subsidiaries and branches which are located in the Eurozone are likely to be quite significant. Institutions which fall under the direct supervision of the ECB enjoy full advantages from the new regime and only deal with one supervisor. Therefore, notwithstanding the discrepancies between their domestic regimes, these groups, branches and subsidiaries are subject to the same supervisory regime regardless of their location. Conversion from subsidiary to branches is likely to become more frequent, as this may result in a better use of capital, including full exploitation of economies of scale, as well as considerable savings in administrative and legal costs. Moreover, other formalities, including reporting, should be centralized and significantly simplified; assessment will take place on a fully consolidated basis allowing for a better risk spreading. These advantages, however, exclusively exist at prudential level.[103] If local authorities have implemented diverging obligations, requirements and practices, these standards would nevertheless remain in place and continue to be different from State to State.[104]

According to the guidelines of the ECB, banks which are supervised nationally should be subject to a simplified supervisory regime, especially considering their marginal impact in terms of financial risk. However, if these banking groups operate in multiple Member States they would still be subject to several diverging regimes unless they convert subsidiaries into branches. On the other hand, little has changed for banking groups from non-participating Member States. Unless they restructure into subsidiaries, which would then remain under the supervision of national authorities, the ECB has now authority over incoming branches and services. When branches are converted into subsidiaries the SSM Regulation requires the conclusion of

[102] *See* WYMEERSCH, *supra* note 41, at 36.
[103] *See* Benedikt Wolfers & Thomas Voland, *Level the Playing Field: the New Supervision of Credit Institutions by the European Central Bank*, 51 COMMON MKT. L. REV. 1463 (2014).
[104] *See* WYMEERSCH, *supra* note 41, at 37.

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a MOU between the ECB and the supervisors of the non-participating States.[105]

6. THE ECB AS A PRUDENTIAL SUPERVISOR. GOVERNANCE AND POWERS

The governing bodies of the SSM are the Governing Council and the Supervisory Board. The former was already operating at the top of the ECB and it comprises the members of the Executive Board as well as the governors of the national central banks.[106] The latter is an "internal organ" of the ECB,[107] which carries out preparatory activities, including specific competences of national supervisors.[108] It is necessary to draw a line between these tasks and the maintenance of price stability which is the primary objective of the ECB's monetary policy.[109] As stated in the preamble to the SSM Regulation, supervisory duties must be fulfilled separately in order to avoid interferences and ensure that each function is carried out in accordance with its specific objectives. Article 25 of the Regulation indeed contains both abstract principles and practical guidelines for achieving a complete separation between supervisory duties and monetary policy.[110] First, monetary policy and prudential supervision must be kept separate. No prejudice to the monetary policy should stem from the exercise of supervisory tasks. Indeed, supervisory duties should neither interfere nor influence the monetary policy of the ECB.[111] In addition, the organization and

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[105] *See* SSM Regulation, *supra* note 20, pmbl. 14, dealing with the effects of the ECB's decision on branches and subsidiaries of SSM banking group in non-participating states, and vice versa. Here a MOU should intervene, including the ECB and the national supervisors.
[106] On the composition of the Governing Council see C. ZILIOLI AND M. SELMAYR, THE EUROPEAN CENTRAL BANK (Giuffré, 2007) and R. SMITS, THE EUROPEAN CENTRAL BANK: INSTITUTIONAL ASPECTS (1997).
[107] *See* SSM Regulation, *supra* note 20, art. 26(1).
[108] *See* SSM Regulation, *supra* note 20, pmbl. 67.
[109] About the need to ensure a clear separation between monetary policy and supervisory tasks, see PISANY-FERRY, SAPIR, VERON & WOLFF, *supra* note 2, at 10, and ECB, Opinion of November 27, 2012 on the proposal for a Council Regulation entrusting the European Central Bank with specific tasks concerning policies relating to the prudential supervision of credit institutions and on the proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 1093/2010 Establishing the European Banking Authority (EBA), 2013 O.J. (C 30) 6, http://www.ecb.europa.eu/ecb/legal/pdf/c_03020130201it00060011.pdf.
[110] *See* HANSPETER K. SCHELLER, *The European Central Bank: History, Role and Functions*, ECB.EUROPA.EU (Oct. 25, 2004), https://www.ecb.europa.eu/pub/pdf/other/ecbhistoryrolefunctions2004en.pdf.
[111] *See* Code of conduct for the members of the Supervisory Board of the ECB (2015/C93/02), https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmlegalframeworkforbankingsupervision.vol3.en.

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hierarchy of the personnel which performs supervisory tasks keeps them separate from other employees within the ECB.[112] As a consequence, based on whether they perform functions of monetary policy or supervision, the agenda and meetings of the Supervisory Board are kept separate.[113] Lastly, the separation between supervision and monetary policy is ensured by creating a Mediation Panel. The Panel deals with the different views of the competent authorities of participating States with respect to an objection of the Governing Council to a draft decision of the Supervisory Board.[114] Each participating States can appoint to the Panel one member which is to be chosen among the members of the Governing Council and the Supervisory Board. All votes count equally and the Panel decides by simple majority.[115]

In particular, the Supervisory Board consists of a chairman and a vice-chairman, four representatives of the ECB (which do not perform tasks which are directly related to the monetary functions of the Bank) and a representative of the national authority which is responsible for the supervision of credit institutions in each participating State. The chairman is selected among persons of recognized standing and professional experience in banking and financial matters. Members of the Governing Council are automatically excluded. The Vice-Chairman is chosen among the members of the Executive Board of the ECB. For both positions, the ECB shall transmit to the European Parliament a proposal of appointment and wait for the approval. Once the proposal is approved, the Board shall appoint the Chairman and Vice-Chairman of the Supervisory Board. These positions are full time and incompatible with other positions with the competent national authorities.[116]

The decisions of the Supervisory Board are adopted by the simple majority of its members. Each member has one vote, but in the event of a draw, the vote of the Chairman is decisive. Exceptionally, regulations are

[112] *See* SSM Regulation, *supra* note 20, art. 25(2).
[113] *See* S. ANTONIAZZI, LA BANCA CENTRALE EUROPEA TRA POLITICA MONETARIA E VIGILANZA BANCARIA [EUROPEAN CENTRAL BANK BETWEEN MONETARY POLICY AND BANKING SUPERVISION] (2014).
[114] On the Mediation Panel see the ECB Annual Report on supervisory activities (2014), https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmar2014.en.pdf.
[115] *See* SSM Regulation, *supra* note 20, art. 25(5).
[116] *See* SSM Regulation, *supra* note 20, art. 26(1) and (3).

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adopted by qualified majority.[117] The Supervisory Board established an internal Steering Committee made up of its own members. The Committee provides support to the activities of the Supervisory Board, including the preparation of meetings.[118] However, it has no decision-making powers.[119] The Supervisory Board plans and executes the tasks which have been assigned to the ECB and acts under the supervision of the Governing Council. All final decisions pertain to the competence of the Governing Council and are adopted by tacit consent. This mechanism purports to avoid that supervisory decisions are overturned as a consequence of the direct involvement of the Governing Council. In fact, the Supervisory Board, after the preparatory work, submits to the Governing Council its draft decisions. Draft decisions are automatically adopted unless the Governing Council objects within ten working days.[120]

A special provision applies to participating States whose currency is not the euro. As noticed before, they participate to the Supervisory Board, but they are not members of the Governing Council of the ECB. Pursuant to art. 7 (8), a participating Member State whose currency is not the euro shall notify the Governing Council when it disagrees on a draft decision of the Supervisory Board. The notification, which is to be drafted within five working days upon receiving the decision. The Governing Council decides on the merits of the dissent within five working days, by taking into account the motivations of the dissenting State. The State is also entitled to ask the ECB to immediately terminate the close cooperation agreement.

Special attention is given then to the independence of the ECB from the competent national authorities. The accountability of the ECB vis-à-vis the European Parliament, the Council and national parliaments is also to be illustrated.[121] Firstly, the members of the Supervisory Board and of the Governing Council shall act independently and objectively in the interest of

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[117] *See* SSM Regulation, *supra* note 20, art. 26(6) and (7).
[118] *See* SSM Regulation, *supra* note 20, art. 26(10).
[119] *See* EUROPEAN CENT. BANK, *Rules of Procedure of the Supervisory Board of the European Central Bank*, ECB.EUROPA.EU(Dec.15,2014),https://www.ecb.europa.eu/ecb/legal/pdf/rop_sb_consolidated_version.pdf.
[120] *See* SSM Regulation, *supra* note 20, art. 26(8).
[121] *See* SSM Regulation, *supra* note 20, artt. 19 and 20. *See* DONATO MASCIANDARO & MARIA NIETO, *Governance of the Single Supervisory Mechanism: Some Reflections* (Baffi Ctr. Research, Working Paper No. 149, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2384594.

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the whole Union. They should not seek or take instructions from communitarian institutions or bodies, Member States governments or other entities.[122] Secondly, the ECB responds to the European Parliament and to the Council for the implementation of supervisory tasks under the Regulation. The ECB then transmits an annual report to the European Parliament, to the Council and to the Eurogroup. The same document is also transmitted to the national parliaments of participating Member States.[123] Moreover, the Eurogroup may host hearing sessions with the President of the Supervisory Board of the ECB with regard to the execution of supervisory tasks. On the other hand, the European Parliament may, when necessary for exercising its powers in accordance with the TFEU, require the Chairman of the Supervisory Board to attend *in camera* hearings before the relevant committees. In particular, practical arrangements between the ECB and the European Parliament should be implemented in order to ensure full confidentiality, as required by the relevant rules.[124]

National parliaments of participating States may invite the Chairman, as well as other members of the Supervisory Board, to discuss with a representative of the competent national authority the supervision of credit institutions within their jurisdiction.[125]

In order to fund the supervisory activities of the ECB credit institutions, as well as branches which have been established in a participating Member State by a credit institution whose main place of establishment is in a non-participating State, pay annual contributions.[126] These fees, which should not exceed the actual costs of supervision (according to artt. 4 to 6 which illustrate its supervisory duties) will be calculated according to objective criteria, such as for instance the relevance

[122] *See* SSM Regulation, *supra* note 20, art. 19(1).
[123] *See* SSM Regulation, *supra* note 20, art. 20(2).
[124] *See* SSM Regulation, *supra* note 20, art. 20(6) and (8).
[125] *See* SSM Regulation, *supra* note 20, art. 21.
[126] *See* SSM Regulation, *supra* note 20, art. 30(1).

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and risk profile of individual credit institutions.[127] Furthermore, competent national authorities are responsible for enforcing these payments, as well as for recovering the costs which arise from their duties to cooperate with and assist the ECB.[128]

In order to ensure high supervisory standards, the ECB shall apply relevant EU law, which is broadly defined as encompassing all national acts which implement EU directive. To that effect, all guidelines, recommendations and decisions of the ECB should comply and be subject to the requirements of Union law.[129] The ECB may also adopt Regulations to the extent necessary to organize or clarify the modalities of its supervisory tasks.[130]

In this respect, however, it must be highlighted that the semi-strong harmonization of the single rulebook for the supervised entities, which is the foundation of the banking union as well as an important precondition of the SSM, could be a potential flaw of the present regime.[131]

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[127] *See* Regulation (EU) 1163/2014 of the European Central Bank of 22 October 2014 on supervisory fees (ECB/2014/41), 2014 O.J (L 311) 23 and Decision (EU) 2015/530 of the European Central Bank of 11 February 2015 on the methodology and procedures for the determination and collection of data regarding fee factors used to calculate annual supervisory fees (ECB/2015/7), 2015 O.J. (L 84)67,https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmlegalframeworkforbankingsupervision.vol3.en.

[128] *See* SSM Regulation, *supra* note 20, art. 30(3) e (5).

[129] *See* SSM Regulation, *supra* note 20, art. 4(3).

[130] Before adopting a Regulation with regard to matters having a substantial impact on credit institutions, the ECB shall conduct open public consultations and analyze the potential related costs and benefits, unless such consultations and analyses are disproportionate in relation to the scope and impact of the Regulations concerned or in relation to the particular urgency of the matter, in which case the ECB shall justify the urgency. *See* SSM Regulation, *supra* note 20, art. 4(3).

[131] The single rulebook is the foundation of the banking union. It consists in E.U. Regulations, Directives, implementing acts and recommendations, guiding principles and other non-binding instruments that all banks in the European Union must comply with. These rules, among other things, lay down capital requirements for banks, ensure better protection for depositors, and regulate the prevention and management of bank failures.
The European Banking Authority plays a key role in building up of the single rulebook. The EBA is mandated to produce a number of Binding Technical Standards (BTS): legal acts that specify particular aspects of an E.U. legislative text (Directive or Regulation) and aim at ensuring consistent harmonization in specific areas. BTS are always finally adopted by the European Commission by means of Regulations or decisions. At that point they become legally binding and directly applicable in all Member States. This means that, on the date of their entry into force, they become part of the national law of the Member States and their implementation into national law is not only unnecessary but also prohibited. *See* Andrea Enria, Chairperson European Banking Auth., *Developing a Single Rulebook in Banking* (Apr. 27, 2012),http://www.eba.europa.eu/documents/10180/27011/Andrea-Enria-s--Speech-at-CBI-Dublin---FINAL.pdf.

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Member States have, in fact, traditionally enjoyed considerable discretion in the implementation of Directives. The banking system in the Eurozone is indeed characterized by regulatory polycentrism: whereas the SSM provides for a centralized supervisory regime, a plethora of rule-makers is still involved in the process. As a consequence, the ECB conducts its supervisory duties according to the diverging rules of all participating States.[132]

As long as regulation and supervision remain national, cross-border differences in legislation create international frictions and give rise to regulatory arbitrage. However, this is not necessarily a problem for domestic supervisors. Centralized cross-border supervision, on the other hand, may be negatively affected by diverging national legislations.[133] In particular, the ECB may incur into higher information costs as it constantly has to consult national authorities on the applicable rules. In addition, the ECB may encounter issues in the interpretation of national legislation implementing EU Directives. The ECB will also face challenges in areas where no common rules are in place, such as for example non-performing loans, for which accounting standards and prudential requirements largely differ from one jurisdiction to the other.[134]

On the other hand, the ECB has the same powers which are available to competent supervisory authorities according to EU law.[135] To the extent necessary to carry out its tasks under the SSM Regulation, the ECB may

[132] *See* Guido Ferrarini & Fabio Recine, *Verso un Testo Unico Bancario Europeo* [*Towards a European Single Banking Act*], BANCARIA, Jun. 2015 (It.).

[133] For an analysis, see WYMEERSCH, *supra* note 41, at 12.

[134] *See* Sabine Lautenschläger, Member of the Exec. Bd. of the ECB & Vice-Chair of the Supervisory Bd., Single Supervisory Mechanism, *After one year of European banking supervision, have expectations been met?* (Jan. 13, 2016), which is available at https://www.bankingsupervision.europa.eu/press/speeches/date/2016/html/se160113.en.html.

[135] According to SSM Regulation, *supra* note 20, art. 9(1), "for the exclusive purpose of carrying out the tasks conferred upon it by art. 4(1), (2) and 5 (2), the ECB shall be considered, as appropriate, the competent authority or the designated authority in the participating Member States as established by the relevant Union law. For the same exclusive purpose, the ECB shall have all the powers and obligations set out in this Regulation. It shall also have all the powers and obligations, which competent and designated authorities shall have under the relevant Union law, unless otherwise provided for by this Regulation. In particular, the ECB shall have the powers listed in Sections 1 and 2". *See* Marcello Clarich, *I Poteri di Vigilanza della Banca Centrale Europea* [*ECB's Supervisory Authority*] *in* L'ORDINAMENTO ITALIANO DEL MERCATO FINANZIARIO TRA CONTINUITÀ E INNOVAZIONI (Alessio Bartolacelli, Vincenzo Calandra Buonaura, Filippo Rossi eds., 2014.) (It.)

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instruct national authorities to utilize their powers when the Regulation does not confer this authority upon the ECB itself.[136]

In particular, the ECB is vested with broad investigatory powers: it can request credit institutions, as well as other legal or natural persons, to provide information. Additionally, the ECB can conduct all necessary investigations on any relevant person. This includes on-site inspections of its business premises (after being authorized by a judicial authority if the applicable national law so requires).[137] National authorities will also assist the ECB in the exercise of their specific supervisory powers in relation to the authorization of credit institutions and assessment of acquisitions of qualifying holdings.[138] Furthermore, the ECB is empowered to require institutions to exceed their capital requirements; to reinforce arrangements, processes, mechanisms and strategies; to present a plan to restore compliance with supervisory requirements; to apply a specific allocation policy; to restrict or limit their business, operations or network; to limit variable remuneration; to invest their net profit into strengthening their own funds.[139]

The ECB can merely sanction breaches by legal persons of immediately enforceable acts of Union law. Otherwise, the ECB may require competent national authorities to initiate proceedings in order to ensure that effective, proportionate and dissuasive sanctions are implemented.

The legal position of the aforementioned credit institutions *vis-à-vis* the ECB is also to be properly eviscerated.[140] The Administrative Board of Review internally revises the decisions of the SSM. However, even though the SSM Regulation mentions a right to judicial review, no procedure is currently in place.

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[136] *See* SSM Regulation, *supra* note 20, art. 9(1), last period.
[137] *See* SSM Regulation, *supra* note 20, artt. 10 - 13.
[138] *See* SSM Regulation, *supra* note 20, artt. 14(2) and 15(2).
[139] *See* SSM Regulation, *supra* note 20, art. 16(2).
[140] For an overview of the legal position of the credit institutions versus the ECB see Tomas M.C. Arons, *Judicial Protection in* EUROPEAN BANKING UNION (Guido Ferrarini and Danny Busch eds., 2015); Raffaele D'Ambrosio, *Due Process and Safeguards of the Persons Subject to the SSM Supervisory and Sanctioning Powers,* QUADERNI DI RICERCA GIURIDICA DELLA BANCA D'ITALIA, Dec. 2013, at 1.

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The decisions of the ECB can directly affect individual credit institutions. The ECB can also issue binding decisions and instructions to national authorities in relation to individual credit institutions. The SSM Regulation does not provide for the right to appeal against subsequent decisions by national authorities. When the ECB asks for the intervention of national authorities, and the national laws of the participating State applies during that procedure, issues of applicable law and jurisdiction need to be discussed. The CJEU, as well as national administrative courts, might be able to exercise jurisdiction over a potential dispute. The latter would then presumably apply national rules of procedure.[141] The effectiveness of the SSM might be undermined by the absence of clear division of judicial competences.[142]

In particular, the directly applicable decisions of the ECB are subject to a two-fold system of review. Internal administrative review, as well as external judicial review can both be relevant. The procedure of administrative review is described in art. 24 of the SSM Regulation. Upon request by the affected institution, the Administrative Board of Review has to carry out an internal administrative review of the decision of the ECB.[143]

However, the scope of paragraph 1 of art. 24 is still to be assessed. It is doubtful whether direct decisions by the ECB qualify for the purposes of internal review when they are taken in accordance with national legislation. This issue is especially relevant when the applicable national statute is, in fact, implementing an EU directive. Even though national law applies, the competence of the ECB stems from the SSM Regulation. Therefore, the decisions of the ECB are not subject to judicial review at national level even if they apply national statutes. Indeed, "EU decisions" (here defined as

[141] *See* Kerstin Neumann, *The supervisory powers of national authorities and cooperation with ECB - a new epoch banking supervision*, 25 EUZW BEILAGE 9 (2014) stating that "the SSM creates complex classification issues and requires further in-depth analysis regarding the legal implications of different ECB actions. As far as the current understanding suggests, the SSM Regulation permits multiple legal proceedings which may cause inconsistent results within different *fora* that make up the SSM".
[142] *See* Arons, *supra* note 140, at 10.05.
[143] *See* D'Ambrosio, *supra* note 140, at 84.

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decisions which have been taken by a EU institution) are reviewed by EU courts.[144]

The scope of the internal administrative review is circumscribed to the procedural and substantive conformity of the decision of the ECB with the SSM Regulation.[145] On the basis of art. 253 (5) of the TFEU,[146] the ECB has adopted the Operating Rules of the Administrative Board of Review.[147]

In particular, after ruling on the admissibility of the request, the Administrative Board of Review has to express an opinion no later than two months upon receiving the request. Within this timeframe, the duration of the procedure can vary on the basis of the urgency of the matter. This opinion must be sent to the Supervisory Board of the ECB for the preparation of a new draft decision. The Supervisory Board must submit to the Governing Council a new draft decision which takes into account the opinion of the Administrative Board. If the Governing Council does not object within 10 working days after the submission, the draft decision is automatically adopted. The draft decision can abrogate, confirm or replace the initial decision.[148] Both the opinion by the Administrative Board of Review and the draft decision need to be motivated and must be notified to the parties.[149] The request of review, however, does not suspend the decision. On the other hand, after receiving a proposal from the administrative board, the Governing Council may suspend the application of the contested decision when the circumstances so require.[150]

[144] The following formalities have to be fulfilled. The request for review must be made in writing, including a statement of grounds, within one month of the date of notification of the ECB decision to the person requesting the review. In the absence of notification, the time limit starts as of the day on which the ECB decision came to the knowledge of the person requesting the review.

[145] *See* SSM Regulation, *supra* note 20, art. 24(1).

[146] *See* TFEU, *supra* note 51, art. 263 (5), stating that "Acts setting up bodies, offices and agencies of the Union may lay down specific conditions and arrangements concerning actions brought by natural or legal persons against acts of these bodies, offices or agencies intended to produce legal effects in relation to them".

[147] *See*, European Central Bank Decision 2014/16 of on the Establishment of the Administrative Board of Review and its Operating Rules, 2014 O.J. (L 175) 47 (Apr. 14, 2014), https://www.ecb.europa.eu/ecb/legal/pdf/oj_jol_2014_175_r_0017_en_txt.pdf.

[148] *See* SSM Regulation, *supra* note 20, art. 24(7).

[149] *See* SSM Regulation, *supra* note 20, art. 24(9).

[150] *See* SSM Regulation, *supra* note 20, art. 24(8).

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Article 24 (11) of the SSM Regulation explicitly states that the abovementioned proceedings of administrative review do not prejudice the right to initiate a claim before the CJEU under the relevant Treaty law. According to article 263 of the TFEU,[151] third parties can ask the CJEU to review the legality of acts of bodies, offices and agencies of the EU when they produce legal effects *vis-à-vis* a third party.[152] All natural and legal persons can initiate proceedings before the CJEU when the contested act has either been addressed to them or it could potentially impinge upon their rights. The right to judicial review remains intact even when the contested act does not have any practical impact.

In conclusion, on the basis of the aforementioned art. 263 of the TFEU all decisions by the ECB which directly address a credit institution fall within the purview of the CJEU. Furthermore, according to paragraph 5 of art. 24 of the SSM Regulation any natural or legal person can challenge a decision of the ECB if that decision is directly addressed to them or if it directly affects their interests.[153]

It is however doubtful whether, on the basis of art. 263 of the TFEU, the CJEU could review decisions of the ECB when the decision making powers of the ECB stem from a national statute, including statutes implementing EU Directives on financial supervision. However, when the decision of the ECB does not directly address the plaintiff or affect its interests the case could be declared inadmissible. On the other side, standing will be granted if the decision of the ECB directly affects a credit institution.[154] In general, it could be desirable to apply national administrative statutes, as interpreted by national courts. However, according to art. 263 of the TFEU the jurisdiction of the CJEU encompasses, but it is not limited to, directly applicable E.U.

[151] *See* TFEU, *supra* note 51, art. 263, paragraph 1.
[152] The European Central Bank is an E.U. institution. *See* Consolidated version of the Treaty on European Union art. 13(1), Jun. 7, 2016, 2016 O.J. (C 202) 13 [hereinafter TEU].
[153] *See* SSM Regulation, *supra* note 20, art. 24(5).
[154] *See* TFEU, *supra* note 51, art. 263(2).

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law.[155]

A fundamental point to determine is whether indirect ECB decisions or instructions to national authorities can be subject to judicial review. Furthermore, if they can be subject to review it is important to determine what court is competent to hear the case. These questions are to be answered by assessing the nature of the decisions and instructions of the ECB. According to art. 263 of the TFEU the applicant must be directly affected by the decision of a E.U. institution. Alternatively, the applicant must have a direct interest in the outcome of the decision. First of all, ECB decisions clearly qualify as acts of a E.U. institution. Decisions, however, are not directly addressed to credit institutions. The ECB instructs national authorities on the issuance of supervisory decisions. As the decision is not directly applicable there is no legal standing on the basis of the first ground for revision.

However, the second ground could be met. The ECB indeed instructs national authorities to take a decision which affects the interests of individual credit institutions.

Since national authorities mediate between the original decision of the ECB and the final addressee, the issue of 'direct interest' is of critical importance in order to seek remedy against the original decision before the CJEU. 'Direct interest' is only established when the intermediate authority, in this case the national authority, has no autonomous or discretionary decision-making power.[156] These criteria are met if national authority merely implements the decisions of the ECB. Implementation is to be automatic, and stem from the direct application of E.U. law. It is therefore fundamental to

[155] *See* SSM Regulation, *supra* note 20, pmbl. 60, "Pursuant to Article 263 TFEU, the CJEU is to review the legality of acts of, inter alia, the ECB, other than recommendations and options, intended to produce legal effects vis-à-vis third parties". In regard instead of admissibility, the following formality is important. TFEU, *supra* note 51, art. 263(5), provides the proceedings must be instituted within two months of the publication of the ECB decision, or of its notification to the applicant, or, in the absence thereof, of the day on which it came to the knowledge of the latter, as the case may be.

[156] *See* Stichting Woonlinie and Others v. European Commission, No. 133-12, ECLI:EU:C:2014:105 EUR-Lex (CJEU Feb. 27, 2014). *See also* KOEN LENAERTS, IGNACE MASELIS AND KATHLEEN GUTMAN, EU PROCEDURAL LAW (2014).

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assess whether there is some discretion as to the implementation of the original decision of the ECB.[157]

Thus, the legal standing of the credit institution depends on the degree of detail of the ECB instructions.[158] On the one hand, if the ECB decision itemizes what rules find application and how they are to be implemented, affected credit institutions will be able to claim before the CJEU as national authorities have no discretionary powers. National authorities are merely formal intermediaries. On the other hand, if the ECB merely lists the objectives, or otherwise leave national authorities with some degree of discretion (e.g. on the use of supervisory powers) credit institutions have no claim before the CJEU, even if the discretionary powers of national authorities are relatively minor. Moreover, it is important to notice that the competent national administrative courts cannot void the original decision or instruction of the ECB. Therefore, credit institutions have no effective remedies against the original decision. Indeed, as partial standing has not been provided for, affected third parties have no way of independently challenging the non-discretionary instructions.

The potential for conflicting judicial decisions increases if the ECB decision and the decision of the national authority are reviewed by two different courts. This is a clear issue in the administrative and/or judicial review of national authorities decisions, which follow the instructions of the ECB.[159] Furthermore, when national authorities are left with no discretionary decision-making powers, judicial review before domestic courts may encounter obstacles. For example, national authorities may argue that, since it had no discretionary power no remedies are available under national administrative law. National administrative courts cannot void the decisions of the ECB, as they are merely competent for the acts of local administrations. Therefore, national courts may declare the claim inadmissible as the affected financial institution has no sufficient interest in contesting the "decision" of the national authority. Indeed, even if the national decision is declared void, the national authority is nevertheless

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[157] *See* LENAERTS, MASELIS AND GUTMAN, *supra* note 156, at 7.91-7.92.
[158] *See* Arons, *supra* note 140, at 13.31.
[159] *See* Arons, *supra* note 140, at 13.32.

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bound to implement the instructions of the ECB. Therefore, the decision would also have to be challenged before the CJEU. However, as mentioned earlier, as partial standing is not a viable path the CJEU is likely to reject the claim when some autonomous decision-making power rests with the national authorities.

The effectiveness of the SSM reform may be further weakened by the absence of clear judicial protection. Sometimes, when national authorities are given little discretion, or even no discretion, individual credit institutions have to challenge both decisions. Indeed, if the ECB decision is left unchallenged, a successful challenge of the local decision would lead to no actual remedy. For this reason, national courts could declare the claim inadmissible for lack of sufficient interest, especially considering that the instructions of the ECB cannot be challenged before national courts. On the other hand, if the decision of the national authority is not challenged and the national authority enjoys some autonomous decision-making power the annulment of the ECB decision may not suffice. Even though art. 266 of the TFEU requires the ECB to comply with the ruling of the CJEU and to instruct national authorities to do the same, the autonomous decisions of national authorities are not directly affected.

Moreover, this could generate conflicting court decisions. Whereas the ECB decision can indeed only be challenged before the CJEU, the decisions of national authorities are to be brought before national administrative courts. No remedy to this situation is currently in place. Indeed, no request can be filed to suspend domestic proceedings if the same case is pending before the CJEU. Additionally, the current system might give rise to some inequalities within the EU. As different substantive and procedural administrative laws apply the chances of conflicting decisions among participating States are rife. A possible solution would be to centralize the judicial review so as to reflect the current supervisory policy, as well as the concentration of decision-making powers. On the other hand, the E.U. dispute resolution mechanism would have to interpret national administrative law if E.U. directives, as well as regulations, leave to national authorities some autonomy in the phase of

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implementation.[160] Since E.U. provisions normally itemize a range of pre-established options, the CJEU would have to ascertain whether domestic authorities have respect the boundaries imposed by E.U. law.

As a further obstacle to centralization, the CJEU, as well as national courts, is already dealing with overcrowded dockets.

7. THE RELATIONSHIP BETWEEN THE ECB AND THE OTHER E.U. SUPERVISORS

One of the most delicate points of the SSM reform concerns the relationship between the ECB and E.U. supervisors.[161]

With regard to the European Banking Authority, the explanatory memorandum accompanying the SSM proposal emphasized the role and existence of the EBA without significant changes in its composition and tasks.[162] In the final draft most of these issues were abandoned and transferred to the EBA amended Regulation,[163] which was discussed and approved together with the SSM proposal.

Some might have expected that it would have been logical to entrust the EBA with prudential supervision. The EBA was only operational in 2011 and it was put in charge, *inter alia,* of "improving the functioning of the internal market by implementing a thorough, effective and consistent level of regulation and supervision".[164] There were, however, several legal impediments that prevented the EBA from being in charge of the SSM. For instance, the Treaty, as well as the prevailing jurisprudence, did not allow for discretionary decisions to be delegated to independent bodies[165]. First of all,

[160] *See* T. Arons, *supra* note 140, at 13.93.
[161] *See* STEFANO CAPPIELLO, *The interplay between the EBA and the Banking Union* (Robert Schuman Ctr. for Advanced Studies Research, Working Paper No. 77, 2015), http://cadmus.eui.eu/bitstream/handle/1814/37378/RSCAS_2015_77.pdf?sequence=1. *See also* Wymeersch, *supra* note 41.
[162] *See* European Court of Auditors, *'European banking supervision taking shape -EBA and its changing context'* (2014), http://www.eca.europa.eu/Lists/ECADocuments/SR14_05/SR14_05_EN.pdf.
[163] *See* EBA amended Regulation, *supra* note 21.
[164] *See* EBA amended Regulation, *supra* note 21, art. 1(5)(a). This was the opinion in the UK: *see* House of Lords, *The Impact of Banking Union on the EBA and the ESRB* (Dec., 2012), http://www.publications.parliament.uk/pa/ld201213/ldselect/ldeucom/88/8806.htm. *See also* Eilis Ferran & Valia Babis, *The European single supervisory mechanism,* J.CORP.L.STUD. (2013).
[165] On the "Meroni doctrine" of the Court of Justice of the European Union, see *supra* text accompanying note 39.

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the EBA implements "horizontal" cooperation not only between the eighteen Eurozone authorities, but also between the twenty-eight national legislators; as opposed to the SSM where every significant bank is represented by one delegate whose authority in the participating States is vertical. Furthermore, the EBA's activities do not normally involve supervision and mainly focus on regulation and standard setting; therefore whereas the ECB will be acting as an independent supervisor[166], the EBA is essentially an agency of the Commission.[167] It is then reasonable to assume that the EBA's slightly modified functions will ensure the even application of the EBA Regulation to the twenty-eight Member States. The internal financial market will thus remain cohesive by avoiding the creation of a two-speed Europe. This concern has been one of the main focuses throughout the discussion of the SSM reform.[168]

In order to overcome this issue, the EBA Amended Regulation modifies the balance between the standard setting powers of the EBA and the ECB which acts as a new powerful banking supervisor for the Eurozone.[169] Whereas the relative position of the ECB as prudential supervisor has been weakened the powers of the EBA have been increased. However, the core powers of the EBA have not been altered by this process. The EBA will continue to be in charge of implementing and enforcing regulatory provisions (artt. 10 and 17 to 19). Implementing Regulations will be adopted solely by the European Commission. The enforcement is largely depending upon the procedures of the Commission. Individual decisions will have to closely follow the literal meaning of the directly applicable acts by avoiding discretionary judgments.[170]

The main changes with respect to the previous EBA Regulation have had an impact on the way the EBA conducts its competences. The new regime

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[166] *See* Veron, *supra* note 28, at 2.10, for a political explanation: the United Kingdom wanted to have a countervailing force against an all-powerful ECB. Obviously the argument has received attention.

[167] Although more independent than most other agencies. *See* CHRISTOS VI. GORTSOS, *The European Banking Authority within the European System of Financial Supervision* (European Ctr. Of Econ. & Fin. Law, Working Paper No. 1, 2011), which is available at http://www.ecefil.eu/UplFiles/wps/WORKING%20PAPER%20SERIES%202011_1.pdf.

[168] *See* House of Lords, *supra* note 164, at 27.

[169] *See* Niamh Moloney, *European Banking Union: Assessing its Risks and Resilience*, COMMON MKT. L. REV. (2014).

[170] *See* WYMEERSCH, *supra* note 41, at 67.

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has strived to grant equal powers to all supervisory bodies which act "independently and objectively and in a non-discriminatory way in the interest of the E.U. as a whole".[171] As the drafters were concerned that the ECB would have occupied a dominant position with respect to other supervisory bodies,[172] the ECB, despite being given adequate representation on the Board of Supervisors of the EBA,[173] has no right to vote. National supervisors, including those of non-participating States, qualify as voting members.

The EBA amended Regulation contains a plethora of provisions which strengthen the EBA's position in order to avoid "centrifugal" forces in an effort to re-balance the powers of the EBA with respect to the ECB.[174]

The EBA is, *inter alia*, responsible for the development of a "European Supervisory Handbook for the whole Union".[175] The Handbook itemizes the best practices, methodologies and procedures. Although this may seem to limit to the ECB's discretion in developing its own supervisory techniques. The Handbook will, indeed, be utilized by the EBA for peer reviews, as well as for the assessment of supervisory practices. It contains traditional supervisory tools which implement soft law instruments. The Handbook's purpose is to avoid supervisory competition between supervisors.[176] By reviewing the way in which the Handbook has been implemented, the EBA might advise the Commission that "legislative initiative is needed to ensure further harmonization of prudential definitions and rules".[177] The EBA Regulation indeed states that the Handbook will not be a legally binding act

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[171] *See* EBA amended Regulation, *supra* note 21, art. 1(5).
[172] *See* WYMEERSCH, *supra* note 41, at 67.
[173] *See* EBA amended Regulation, *supra* note 21, art. 4(c); the representative will not necessarily come from the ECB, having been nominated by the Supervisory Board. However a second representative "with expertise on central banking tasks" may accompany the ECB representative (EBA amended Regulation, *supra* note 21, art. 4(c) and (b)).
[174] *See* Jacques De Larosière, *Privilégier une structure légère mais aux aguets*, 757 BANQUE (2013); V. Constâncio, Vice-President, European Cent. Bank, *The nature and significance of Banking Union* (Mar. 11, 2013), www.ecb.europa.eu/press/key/date/2013/html/sp130311.en.html, who considers that the stronger centralization at the ECB will benefit the coordination role of the EBA.
[175] *See* EBA amended Regulation, *supra* note 21, art. 8(1)(a).
[176] *See D. Nouy, Un superviseur adossé à la BCE est un vrai avantage, Banque,* 757 BANQUE (2013); *N. Veron, L'EBA, arbitre des différends entre le Royaume-Uni et l'Union bancaire,* 757 BANQUE (2013) (*considering that the development of a single Handbook will be very difficult with the United Kingdom as main interlocutor).*
[177] *See* Nouy, *supra* note 176, at 24-26, who sees it as an instrument to support equal competition especially between the centre and the "periphery".

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as it will not have an impact on the supervisory judgement. There is, however, a risk that national supervisors, despite their lack of authority with respect to significant banking groups, may gain control over supervisory procedures.

The competence of the ECB and the EBA are also likely to overlap with regard to the performance of stress tests:[178] the ECB proceeds to stress testing on individual basis and, as a regular part of its supervision, on individual banks.[179] The EBA, on the other hand, autonomously engages in Union-wide "assessments of resilience" in cooperation with the ESRB.[180] To accommodate EBA's requests, both banks and national supervisors, including the ECB, may be directly asked to undertake specific on-site inspections and examinations.[181]

To summarize, the EBA's rights to obtain information from credit institutions has been expanded to banks, holding companies, branches and non-regulated entities within banking groups.[182]

The EBA also supports the development of more efficient supervision programs by promoting joint supervisory plans and examinations.[183] Before the implementation of the EBA Amended Regulation, the EBA had a wide range of powers. After its implementation, the EBA is also entitled to convene a College of Supervisors.[184]

Special arrangements between governments and the EBA have been implemented in order to re-balance the powers of participating and non-participating States.

Article 40 of the EBA amended Regulation The SSM Regulation[185] states that the ECB can participate to the EBA Board of Supervisors. The Supervisory Board will nominate a representative for the ECB, which is not

[178] *See* CAPPIELLO, *supra* note 161, at 8.
[179] *See* EBA amended Regulation, *supra* note 21, art. 44. See Anna Gardella, Banca d'Italia, *Ruolo dell'EBA e della BCE nella Regolamentazione Bancaria Europea* [*The role of EBA and ECB in the European Banking Regulation*] (May 16, 2014).
[180] *See* EBA amended Regulation, *supra* note 21, art. 22(1)(a).
[181] *See* EBA amended Regulation, *supra* note 21, art. 32(3)(a) and (6).
[182] *See* EBA amended Regulation, *supra* note 21, art. 35(6).
[183] *See* EBA amended Regulation, *supra* note 21, art. 21.
[184] *See* EBA amended Regulation, *supra* note 21, art. 20(a).
[185] *See* EBA amended Regulation, *supra* note 21, art. 3 (2).

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necessarily going to be one of its employees.[186] This representative, despite sitting as an observer next to national supervisors, has no right to vote.[187]

Moreover, the ECB representative does not represent the 18 jurisdictions for which it has supervisory capacity. The divergent views expressed by Member States within the Supervisory Board could undermine the achievement of a well-balanced regulation.[188] On the other hand, it is likely that over time the relative weight of the ECB in this debate will lead the EBA to shift its focus on the relationship with supervisors of non-participating States.[189]

When the Board of Supervisors discusses issues which are related to individual financial institutions, non-voting members, with the exception of the representative of the ECB Supervisory Board, do not participate to the meeting. Therefore, the meeting is attended by the ECB representative, the EBA chairperson and the executive director.[190]

As decision-making procedures in the EBA's Board of Supervisors was one of the key elements in convincing certain Member States, along with the European Parliament, to accept the entire SSM this topic deserves to be further explored. Both the original and the amended Regulation stipulate that decisions are adopted by the Board of Supervisors, *i.e.* by the simple majority vote of the twenty-eight national regulators. The votes of participating or non-participating Member States count equally.

Exceptions are nevertheless possible for the few topics. Qualified majority is needed for deciding on regulatory matters (artt. 10 to 15). Qualified majority is achieved by requiring the simple majority of both participating and non-participating States. The increasing influence of the

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[186] *See* EBA amended Regulation, *supra* note 21, art. 40(1)(b).
[187] *See* EBA amended Regulation, *supra* note 21, art. 40(1)(d).
[188] The SSM Commission Proposal, *supra* note 12, gave the ECB the power to "coordinate and express a common position" for the participating Member States: SSM Commission Proposal, *supra* note 12, art. 4(1)(1). *See also* Explanatory Memorandum to the SSM Commission Proposal, *supra* note 12. This approach has been abandoned by the Parliament in the final version, restoring the full freedom of the competent authorities of the participating Member States to agree on subjects within the EBA's competence.
[189] This fear was repeatedly expressed in House of Lords, *supra* note 164, at 28. The House of Lords stated that voting rights should be proportional to the relative significance of the financial markets in the different Member States.
[190] *See* EBA amended Regulation, *supra* note 21, art. 40(4).

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ten non-participating States with respect to the eighteen Eurozone States may negatively affect the conclusion of "close cooperation" agreements. Implementing Regulations, recommendations, and decisions to prohibit or suspend particular financial services obey to this special voting regime.[191] Decisions on breaches of Union law, emergency decisions and dispute settlement can be decided by simple majority. The simple majority threshold is, however, to be achieved by both groups. The decision is approved when participating States, as well as non-participating States, successfully deliberate by simple majority.[192]

On the other hand, if the number of non-participating States goes down to four, or less than four, non-participating States in the European Union, decisions will be adopted by simple majority as long as at least one non-participating State votes in favor of the proposal. If this voting system is implemented the last non-participating State would be able to obstruct the decision–making process. For instance, the United Kingdom, which is likely to be the last long-term dissenter, will have to concur on the proposed measures even when all participating States have already voted in favor of the proposal. The ECB, with the aid of the EBA as mediating authority, will have to directly negotiate with the dissenting State.

In order to prevent stumbling blocks, the Regulation contains a review clause. As soon as the number of non- participating States goes down to four the Commission will propose to review the current voting regime. It is difficult to see how the system could be reviewed without a radical overhaul in the distribution of regulatory and supervisory powers in the European Union.

By moving on to the legal duties of the EBA, the amended Regulation does not have an impact on the Implementing Regulation. No changes have therefore been made to articles 10 to 15, which specifically deal with

[191] *See* EBA amended Regulation, *supra* note 21, artt. 10 - 16 and 9(5).
[192] *See* EBA amended Regulation, *supra* note 21, artt. 17, 18 and 19. For the composition of the conflict resolution Panel, a supermajority of ¾ of the voting members is required, eliminating the need for the double simple majority: EBA amended Regulation, *supra* note 21, art. 44(1) and (6).

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Regulatory Technical Standards, as well as to art. 16 on Guidelines and Recommendations. However, as explained above, these kind of changes is to be adopted by qualified majority. On the other hand, other legal aspects of the EBA have been modified, *i.e.* "Breaches of Union law", "Emergency situations" and "Settlement of disagreements" (artt. 17, 18 and 19).

Whenever a national supervisor is accused of breaching the law of the European Union, the EBA is entitled to act and, under the formal control of the Commission, officially establish the breach. The EBA, for directly applicable acts and in conformity with the formal opinion of the Commission, may then enforce its deliberation.[193] According to the new regime, an independent Panel would have to be appointed.[194] The Panel would be made up of the members of the Board of Supervisors of the EBA which hold no stake in the deliberations. The Panel would then have to formulate a proposal before the Board of Supervisors. This mechanism would submit the ECB to its peer supervisors, including supervisors from SSM jurisdictions. As the Supervisory Board is a non-voting member of the Board of Supervisors, it cannot be part of the Panel that judges breaches in non-SSM States.

The Regulation also illustrates the fashion for implementing emergency actions.[195] The EBA may "adopt individual decisions requiring competent authorities to take the necessary action (...) to address any such developments by ensuring that financial institutions and competent authorities satisfy the requirements laid down in that legislation". As the ECB is a "competent authority", as well as a central bank, it will surely be involved in emergency matters.[196]

The EBA also plays a role in the dispute settlement of disagreements between supervisors in a transnational context. The EBA intervenes in dispute resolution between national supervisors by establishing committees

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[193] *See* EBA amended Regulation *supra* note 21, art. 17(6) and (7); for details see also, WYMEERSCH, *supra* note 41.
[194] *See* EBA amended Regulation, *supra* note 21, art. 41(1) (a). By consensus within the Board of Supervisors, and if not possible, by a ¾ vote: *cf.* EBA amended Regulation, *supra* note 21, art. 44(6).
[195] *See* EBA amended Regulation, *supra* note 21, art. 18.
[196] *See* EBA amended Regulation, *supra* note 21, art. 18(2).

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similar to ones mentioned earlier.[197] In these cases the decisions of the EBA would be directly applicable. Decisions would either be addressed to the competent authorities or, in case of non-implementation, to the individual market participants.[198] However, the EBA has very limited room for discretion. It can only act on provisions that are directly applicable. In other words, once the EBA has identified the applicable rules it can only intervene on the unwillingness of national supervisors to effectively implement them. This also means that the EBA is not creating additional rules, but it is merely implementing already applicable provisions.[199]

When the ECB acts as supervisor for significant banking institutions, or the national supervisor operates under the oversight of the ECB, this dispute resolution mechanism does not apply to disagreements between supervisors of participating States and the ECB.

As a result, art. 19 only encompasses disputes between the ECB and supervisors of non-participating States, as well as conflicts between domestic supervisors of different States. Within the SSM, there is no mechanism for settling disputes between supervisors, as the Governing Council would ultimately judge upon differences of opinion. Its decisions can however be reviewed by the CJEU.

On the other hand, The Regulation does not pay particular attention to the relationship between the ECB and the European Systemic Risk Board (ESRB). The Regulation ignores the ESRB, it merely states that the ECB may replace other supervisory bodies, including the ESRB.[200]

Like the EBA the European Systemic Risk Board was created by the 2010 Reform as a response to the financial crisis. Before the crisis, supervisors focused mostly on the health of individual financial institutions. Therefore, as the overall stability of the financial system was overlooked potential risks to the whole financial sector were underestimated. As a reaction to this failure, the supervisory focus moved to the overall stability of the system ("macro-prudential supervision").

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[197] *See* EBA amended Regulation, *supra* note 21, art. 19(4).
[198] *See* EBA amended Regulation, *supra* note 21, art. 19(3) and (4).
[199] *See* WYMEERSCH, *supra* note 41, at 71.
[200] *See* SSM Regulation, *supra* note 20, art. 3.

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The ESRB is the macroprudential supervisor within the European Union.[201] In contrast with the EBA, after the establishment of the SSM no formal changes to the tasks or membership of the ERSB were introduced, even though after the establishment of the SSM the ECB obtained larger competences and expertise in the field of macro-prudential supervision.[202]

A practical consequence of the ECB's expertise is that SSM countries could frequently take the same stance in the ESRB. If this is the case, the position of the SSM-countries is likely to be the determining factor in the decisions of the ESRB. Eurozone Member States hold 19 of the 38 votes in the SSM. SSM countries therefore almost reach the simple majority of voting members. On the other hand, they would be able to stop the adoption of any decision. Whether the SSM-countries will have an absolute majority in the future will depend on the evolutions of the European Union, as well as SSM, memberships.[203]

Even though it may appear hazardous, the power of the SSM in determining the decisions of the ESRB does not pose any real threat. First of all, national supervisors and the ECB will not always vote in a similar way. Discretionary judgment is always a key factor in assessing the scale of a macro-prudential risk. This will likely lead to diverging voting strategies. Most importantly, the decisions of the ESRB have no binding power. Therefore, even if the SSM could impose its decisions on other members of the ESRB, major consequences would be avoided.[204]

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[201] The essential task of the ESRB is therefore to supervise the financial system in order to detect potential risks that can affect the financial system and the real economy. When such a risk is detected, the ESRB can emit warnings and recommendations to the Member States and other E.U. bodies. The ESRB, however, lacks the competence to make decisions that are binding on others, as the Member States and E.U. bodies are not obliged to act upon the warnings and recommendations issued by the ESRB. In its present configuration, the ESRB is a rather bloated body. In an European Union with twenty-eight Member States, the ESRB has sixty-seven members of which thirty-eight have voting rights. Voting members comprise representatives of all Member States, the President and Vice-president of the ECB and other representatives of E.U. bodies. Most decisions in the ESRB are made by simple majority. A majority of ⅔ is needed only when a recommendation or warning is to be made public.

[202] *See* ESRB, *The ESRB Handbook on Operationalizing Macro-Prudential Policy in the Banking Sector*, ESRB.EUROPA.EU(Mar.,2014),https://www.esrb.europa.eu/pub/pdf/other/140303_esrb_handbook _mp.en.pdf. *See also* Goeffrey P. Miller, *Risk Management and Compliance in Banks: The United States and Europe in* EUROPEAN BANKING UNION (Guido Ferrarini and Danny Busch eds., 2015).

[203] *See* WYMEERSCH, *supra* note 41, at 68-70.

[204] *See* VERHELST, *supra* note 85, at 36-37.

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In conclusion, the general framework of E.U. banking regulation and supervision has been left substantially unaltered by the SSM reform. The ECB shall indeed cooperate with other European authorities[205] such as the ESAs (which include the EBA) and form the ESFS in accordance with the De Larosière report.[206] Moreover, the models of enhanced cooperation and supervision of the general framework of the European Union is not affected by the introduction of the SSM.[207] Whereas Eurozone countries have a centralized supervisory framework, models of enhanced cooperation and supervision still characterize bank supervision in the rest of Europe.

8. BALANCES AND PERSPECTIVES OF THE SSM

This work highlights the weaknesses of the European banking system. The previous banking supervision and resolution framework, which was mainly based on cooperation amongst national authorities, and, as the recent financial crisis has shown, it was therefore doomed to fail in a situation of crisis. Moreover, the absence of common resolution mechanisms and of common deposit guarantee schemes led to an aggravation of the costs of a banking crisis, increasing systemic risk as well as the chances of a bailouts.

In order to overcome the previous fragilities of the European banking system a new major form of centralization and resolution was introduced in the European Banking Union. The SSM, one of the pillars of the European banking union, however, includes elements of cooperation and delegation. On the one hand, this will help the ECB to perform its tasks as a central supervisor. On the other hand, it will give rise to conflicts of interest and information asymmetries which could endanger the effectiveness of the mechanism. The SSM can be described as a semi-strong form of supervisory centralization.[208] Furthermore, the SSM will be limited to the Eurozone. Forms of enhanced cooperation and lead supervisor models will nevertheless apply in the relationships with other countries. Moreover, as already

[205] *See* GUIDO FERRARINI & DANNY BUSCH, *A BANKING UNION FOR A DIVIDED EUROPE* (Guido Ferrarini and Danny Busch eds., 2015).
[206] *See supra* note 13.
[207] *See also* Ferrarini & Chiodini, *supra* note 25, at 8-10.
[208] *See* Ferrarini & Chiarella, *supra* note 1, at 5.

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established by the 2010 reform, the ECB will have to cooperate with the EBA, which will nevertheless keep its regulatory and mediation tasks. As a result, cross-border banking groups will often be subject to substantial supervisory fragmentation. Therefore, the flaws of the previous supervisory framework have not been overcome by the reform.

As highlighted, these flaws could be partially compensated, if the SSM will be extended to a sufficient number of non-euro countries under the close cooperation regime.[209] However, non-euro countries have little incentives to join the SSM. They could benefit from their outsider position by exploiting the voting power of non-euro countries in the Supervisory Board of the EBA.

The SSM Regulation establishes that the European Commission will submit a review report on the functioning of the SSM. This therefore represents a good opportunity to implement the current framework. The report must, *inter alia*, assess the possibilities of developing further the SSM and in particular the appropriateness of the governance arrangements of the SSM. The functioning of the SSM within the ESFS, the division of tasks between the ECB and the national competent authorities within the SSM and the interaction between the ECB and the EBA are also to be ascertained.[210] The report shall be forwarded to the European Parliament and to the Council. The Commission shall then draft accompanying proposals, as it deems appropriate. The hope is therefore that these flaws will be overcome in the future.

At this stage it's still uncertain whether the newly introduced framework will be sufficient to break the connection between sovereign States and banks inside the Eurozone, as still there is no evidence of the SSM reliability. Many structural weaknesses therefore indisputably emerge from the architecture of the SSM. For instance, resources constraints and as well as the difficult balance between the interests of individual Member States

[209] On the regime of close cooperation see *supra* the para. *ad hoc*.
[210] *See* SSM Regulation, *supra* note 20, art. 32.

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and the, often conflicting, interests of the Eurozone. The current framework is, in fact, the outcome of political compromises.[211]

If legal and political constraints had not played a major role in the shaping of the current regime, the SSM would certainly look different.[212] As the role of central banks in prudential supervision has been highlighted by the recent crisis, the ECB probably would still be in charge of the supervisory functions. The allocation of responsibilities between national supervisory authorities and the ECB would however be much more straightforward.[213]

The ECB's remit would be broader. It would continue to include banks while also encompassing other entities, such as for instance systemically relevant insurance companies and providers of market infrastructures.[214] As already highlighted, the breadth of the ECB's remit was nevertheless dictated by art. 127 (6) of the TFEU. If no amendments are implemented, the existing Treaty framework does not allow the SSM to extend its prudential oversight over all systemically relevant factors in the financial market. Although in principle a more elastic approach would have been preferred the SSM reflects a traditional and overly narrow view of the sources of systemic risk. This is one more hint that the design of the current supervisory system is fatally flawed.

Even though piecemeal reforms and technocratic fixes are not ideal it is desirable to implement the current framework in the future.[215]

However, it is important not overlook the major changes in the financial regulation of the Eurozone since 2008. The overhaul of prudential regulation and supervision has been far-reaching. There has been a considerable shift of power from national to European authorities. As

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[211] *See* E. WYMEERSCH, *Banking Union: Aspects of the Single Supervisory Mechanism and the Single Resolution Mechanism Compared* (Univ. of Gent & ECGI, Working Paper No. 290, 2015), http://www.webankon.com/wp-content/uploads/2015/11/SSRN-id2599502_Art.ECGI_Banking-Union.-Aspects-of-the-Single-Supervisory-Mechanism....pdf.
[212] On possible different features of the European banking union see EILIS FERRAN, *European Banking Union: Imperfect, But It Can Work* (Univ. of Cambridge & ECGI, Working Paper No. 30, 2014) (Guido Ferrarini and Danny Busch eds., 2015).
[213] On the possible conflict of interest between the ECB and the relevant national authorities see FERRARINI & CHIARELLA, *supra* note 1, at 51-53.
[214] *See* TFEU, *supra* note 51.
[215] *See* ASHOKA MODY, *A Schumann Compact for the Euro Area*, BRUEGEL.ORG (Nov. 20, 2013), http://www.bruegel.org/publications/publication-detail/publication/802-a-schuman-compact-for-the-euro-area/.

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anticipated, although the connection between banks and sovereign States, which has been the primary cause of the European banking union, has certainly been weakened. Moreover, as a consequence of the crisis the implementation of a E.U. regime for the resolution of failing banks was instituted. It now consist of a sophisticated array of procedures and tools, including bail-in powers that, over time, should considerably reduce the need to call upon public funding.[216]

Those who think that the SSM is an unfinished reform have strong arguments.[217] On the other hand, by taking into account the abovementioned constraints, the argument that the current structure is the best realistically possible outcome is more compelling. In order to strengthen the banking system of the Eurozone, piecemeal reforms which relies on market developments so as to further evolve into a more cohesive framework was probably the best option. Objections to expanding the purview and powers of new institutions do not necessarily set the pace for the evolution of those institutions. Fears can recede in the face of proven institutional usefulness, and issues that were once highly controversial can lose their political saliency while persistent objectors can become accustomed to the new order.[218]

The long term success of the SSM will depend on the operational efficiency and effectiveness of its various components and on its ability to overcome its current limits.

In the meantime, however, the introduction of the SSM helped to change perception and improve the levels of trust and confidence in the market. The current legal framework seems sufficiently robust. Additionally, it enjoys sufficient authority and credibility to help reversing the trend towards financial market disintegration in the EU. Even in its incomplete form, the SSM has had a major stabilizing impact. Even though it is currently

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[216] *See supra* note 23 and accompanying text.
[217] *See, e.g.*, Fritz_Breuss, *European Banking Union: Necessary, but not Enough to fix the Euro Crisis*, CESIFO FORUM, Winter 2012, at 26; A. VON BOGDANDY, et al., *Towards a Euro Union*', BRUEGEL.ORG (Aug. 25, 2014), http://bruegel.org/2014/08/towards-a-euro-union/; Miranda Xafa, *European Banking Union, Three Years on*, 73 CIGI PAPER (2015); S. VERHELST, *Banking Union: are the EMU design mistake being repeated?* (European Policy Briefs, Working Paper No. 12, 2012), http://www.egmontinstitute.be/wp-content/uploads/2013/10/EPB12.pdf.
[218] *See* FERRAN, *supra* note 212, at 3.55.

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impossible to assess whether it has broken the vicious circle between sovereign States and banking institutions it has certainly contributed to its mitigation.[219]

Although the SSM reform presents considerable limits, it is still too early to judge on its effectiveness. It has been implemented with the purpose to overcome the fragility of the previous European banking system by loosening the connection between banks and sovereign debt, which is achieved by transferring sovereignty from the single States to the SSM. This should stop the weakening of the financial market.[220]

The current hope is that Eurozone leaders do not forget what led to these reforms and effectively implement them in the future. Regulations and Directives can effectively be reviewed. These chances to fill the gaps and overcome the flaws of the current system cannot be missed.

In the meantime, the scenario could substantially change if a sufficient number of non-euro countries adhere to the system of "close cooperation" which is established by the SSM Regulation. By entering a close cooperation agreement with the ECB non-euro countries will be subject to almost the same regime as the Members of the Eurozone.[221] By assuming that most E.U. Member States will join the SSM, issues of cooperation between the EBA and the competent authorities of non-participating countries could substantially improve.

The system, however, offers little incentives for joining the banking union. No doubt, systemic stability will benefit from the extension of a common supervisory regime to the majority of the EU, as well as to their banking institutions. However, even though this argument is sound on paper, this will not necessarily determine that this regime is going to be implemented in practice. Indeed, by participating to the SSM Member States would give up most of their supervisory powers in favor of the ECB.

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[219] *See* D. Nouy, Chair of the Supervisory Bd., Single Supervisory Mechanism, *The Single Supervisory Mechanism after one year: the state of play and the challenges ahead* (Nov. 24, 2015), https://www.bankingsupervision.europa.eu/press/speeches/date/2015/html/se151124.en.html.
[220] *See* Fritz Breuss, *The Stabilizing Properties of a European Banking Union in case of Financial Shocks in the Euro Area,* 550 ECONOMIC PAPERS (2015).
[221] *See* SSM Regulation, *supra* note 20, art. 2(1).

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Politicians have few incentives to push for this solution. While the loss of sovereignty would be easily noticeable, voters could easily miss the benefits in terms of systemic stability and financial integration.

Moreover, these benefits will largely depend on how many non-euro countries will decide to join the ECB. If this number is low, incentives to participate will be modest, and therefore issues of collective action will not be easily solved. Furthermore, non-participating Member States are going to enjoy some voting power within the Supervisory Board of the EBA. The current voting system could offer to non-participating States a reason not to join the SSM. Therefore, all recent efforts to rebalance voting powers within the EBA Supervisory Board, which, officially, aim at protecting the financial interests of the Union, could paradoxically make it undesirable for non-euro Countries to join the SSM.

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A Story of Three Bank-Regulatory Legal Systems: Contract, Financial Management Regulation, and Fiduciary Law

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TABLE OF CONTENTS: 1. Introduction; 2. Why is the Depositors' Trust Crucial to the Survival of any Bank?; 3. The U.S. Banks, Their View, and the View of Their Regulators in Maintaining the Trust of Their Depositors and Their investors; 3.1. A bit of History; 4. The Design of Banks and Their Regulation in Japan; 5. Trust-based Banking Law in Israel; 6. Conclusion: Food for Thought.

ABSTRACT: How should banks be regulated to avoid their failure? Banks must control the risks they take with depositors' money. If depositors lose their trust in their banks, and demand their money, the banks will fail. This article describes three legal bank regulatory systems: Contract with depositors (U.S.); a mix of contract and trust law, but going towards trust (Japan), and a full trust-fiduciary law regulating banks (Israel). The article concludes that bank regulation, which limits the banks' risks and conflicts of interest, helps create trustworthy banks that serve their country best.

KEYWORDS: *Banking*; *Trust*; *Regulation*; *United States*; *Japan*.

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1. INTRODUCTION

Banks offer crucial services to society. First, they offer depositors a reliable and safe place to deposit their money, as well as a money transfer service. Second, they intermediate between depositors and borrowers, lending deposit money to reliable borrowers. Banks hold, and have power over, other people's money. Banks intermediate between short-term lenders (depositors) and long-term borrowers.

Yet, by definition, these two services create a risky structure for banks. Deposits are short-term and expect instant liquidity; loans are long-term and undertake payment on specific dates. Depositors expect truly low risk; the risk posed by the borrowers is likely to be higher. In addition to an inherently risky structure, the income from depositors and borrowers may be insufficient to cover banks' cost of services, which may raise another source of risks for banks. Banks attract additional capital by selling their underlying loans in the markets, and to the extent permitted, by offering other financial services. Banks use their profits as backups to protect themselves against "runs," and to reward their employees and managers.

Most importantly, banks cannot survive without their depositors' trust. By definition banks do not hold all their depositors' money in cash. A "bank run" in which more than the usual deposits is demanded by the depositors will cause a bank to fail. To gain the depositors' trust, banks are subject to constraints in using their lending power. Not only the laws, but also the public's view and trust, are crucial to banks' survival anywhere in the world.

The risks to banks cannot be evaluated without considering other financial services that are offered by bank holding companies, under the same roof. These are the bank conglomerates, to which the banks belong. The conglomerates offer underwriting and brokerage, financial advisory services and financial management (e.g. mutual funds), trust services and securitization services, insurance and alike: a one-stop financial service.

The financial services in Bank Conglomerates (BCs) are differently regulated, have different cultures and face different market competition and

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need for customers' trust to a different extent. The purpose of a conglomerate bank is to provide its customers with all financial services. The issue, which these conglomerates face, is how to structure an *overall unified culture*, regardless of the particular laws that may govern each of their services and regardless of the market competition by singular services.

Because banks are crucial to both the economy and the financial system, as well as vulnerable to failures, various countries have regulated their banks. These regulations are designed (1) to prevent banks from making risky loans or engaging in other risky financial activities, and (2) to protect banks from depositors' demands, which the banks cannot meet and could not, perhaps, anticipate: that is, to protect banks from unexpected "bank runs;"[1] and (3) to support bank-stability in many other ways such as providing banks with monopolies over certain services to increase their returns.

Like many other fiduciaries, banks hold, and have power over, other people's money. Banks intermediate between short-term lenders (depositors) and long-term borrowers. To gain the depositors' trust, banks are subject to constraints in using their lending power. Not only the laws, but also the public's view and trust, are crucial to banks' survival anywhere in the world.

Banks are regulated differently in different countries. The regulation is affected by the history of the countries' financial systems, the past bank failures which they suffered, the size of the banks, as well as their national and internal culture. Because today most banks around the world are open to serve most people around the world, these differences may have greater

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[1] *See, e.g.*, John Morley, *The Regulation of Mutual Fund Debt*, 30 YALE J. ON REG. 343, at 361 (2013) (citing RICHARD SCOTT CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 296-307 (4th ed. 2009)) (noting that bank regulation restricts amount of debt banks may carry and regulates riskiness of banks' loans and other asserts); Gregory M. Gilchrist, *The Special Problem of Banks and Crime,* 85 U. COLO. L. REV. 1, at 30-32 (2014) (noting role of reserve requirements and deposit insurance in mitigating risk of runs).

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impact on many more people than the impact they had in the past. The purpose of this article is to learn from these differences.

All banks aim at gaining and maintaining their depositors' and their investors' trust and commitment. In the last analysis, the banks will maintain their trust by limiting their exposure to two main risks: the risk of losing assets, and the risk of losing the depositors' and investors' trust. The following three examples describe in general terms the legal systems in three countries, designed to gain and maintain the banks' depositors and investors' trust.

Like other institutions that hold other people's money, banks hold, and have power over, other people's money. Their services involve risks, and invite regulatory focus. To gain the depositors' trust, banks are subject to constraints in using their power. Not only the laws, but also the public's view and trust, are crucial to banks anywhere in the world.

This Article offers a short review of three different legal systems that regulate banks, and affect their culture. The three banking regulatory versions are the laws in the United States, in Japan, and in Israel. The descriptions focus on the principles forming the foundation of the banks' regulation, their regulators' attitude, and the banks' culture. Considering the importance of banks' trustworthiness, this Article highlights the means by which banks' culture is created, and the means by which their trustworthiness is achieved. These means reflect the culture of the countries in which the banks operate.

Part one of this Article describes bank regulation in the United States. The second part describes the design of banks and their regulation in Japan. The third part discusses bank regulation in the Israel. In conclusion, the comparisons offer food for thought.

2. WHY IS THE DEPOSITORS' TRUST CRUCIAL TO THE SURVIVAL OF ANY BANK?

Banks offer crucial services to society, but these services involve risks, and regulatory focus. The first and foremost public service of banks is to offer depositors a reliable and safe deposit and money transfer service. The second

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service is to lend deposit money to reliable borrowers. By definition, these two objectives create a risky structure for banks. Deposits are short-term, while loans are long-term. Depositors rely on the bank's credit strength, which might be higher than that of the banks' borrowers. The income from depositors and borrowers may not be adequate to fund and compensate bank services. A bank's failure, however, severely injures the financial system.

Hence, in one way or another, countries have regulated banks (1) to prevent them from making risky loans and engaging in other risky financial activities, and (2) to protect banks from depositors' demands, which the banks cannot meet and could not, perhaps, anticipate: that is, to protect banks from unexpected "runs."[2] The United States had its share of bank failures; and in the 1930s Congress designed laws to avoid such failures in the future.[3] Other countries have been engaged in similar preventive activities and regulations. Countries have used different legal systems and techniques to strengthen the depositors' trust in their banks.

Thus, all banks are supported by laws and regulations. Some laws are enabling bank activities (perhaps to increase their profitability), and some are restricting bank activities (to avoid bank risk-taking and losses that might undermine the banking system). Banks attract additional capital by selling their underlying loans in the markets, or by offering various services and by organizing bank holding companies, that issue securities to the public. Banks use their profits as backups to protect themselves against "runs," and to reward their employees and managers.

All banks aim at gaining and maintaining their depositors' and their investors' trust and commitment. In the last analysis, the banks will maintain the trust in them when they limit their exposure to two main risks: the risk of losing assets, and the risk of losing the depositors' and investors' trust. The following three examples describe in general terms the legal systems in three countries, designed to gain and maintain the banks' depositors and investors' trust.

[2] *Id.*
[3] *See* Banking Act of 1933, ch. 89, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

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3. THE U.S. BANKS, THEIR VIEW, AND THE VIEW OF THEIR REGULATORS IN MAINTAINING THE TRUST OF THEIR DEPOSITORS AND THEIR INVESTORS

Banking law in the United States is based on the model of contractual relationships between the banks and their depositors on the one hand and their borrowers on the other hand. Banks borrow from depositors by contract and lend to borrowers by contract. Contract law applies to both types of transactions. Bank holding companies are issuing securities, like any other business. The purpose of the distribution is to raise funds from investors based on the profitability of the banking enterprise. Revenues are designed to satisfy their holding companies' shareholders, as well as their management and employees. The bank holding company is therefore viewed like any other holding company that owns one or more enterprises. Currently bank holding companies hold a variety of financial services. These may include trust services, money management services, brokerage, and underwriting.

3.1. A BIT OF HISTORY

The United States has had its share of bank failures; and in the 1930s Congress designed laws to avoid such failures in the future.[4] These laws have seen fundamental changes. Other countries have been engaged in similar preventive activities and regulations. Countries have used different legal systems and techniques to strengthen the depositors' trust in their banks.

Thus, with the demise of banks in the 1930s, Senator Glass and Representative Steagall led Congress and the bank regulators to enact the Glass-Steagall Act of 1933.[5] This statute prohibited banks from engaging in intermediation among borrowers and lenders in the markets. The statute limited bank intermediation to linking depositors and borrowers, whom the banks could examine and evaluate.

In order to reduce the risk of bank intermediation and to assure depositors, the Act provided banks not only with financial backup (Federal Deposit Insurance Corporation) (FDIC) that offers government guarantees to

[4] *Id.*
[5] *Id.*

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deposits up to $250,000.[6] In addition, the Glass-Steagall Act allowed banks to offer trustee-services for small trusts and fill the gap that opened when trust companies that offered these services failed.[7] Further, the Glass-Steagall Act limited the banks issuance of securities to the markets.[8] Thus, the method of ensuring the banks' stability and reliability was to restrict the ability of the banks to take risks with the depositors' money, as they did during the heyday of the 1920s, and to back bank deposits with government guarantees. In addition, the Act imposed limitations on banks' financial services. Brokerage, underwriting, mutual funds management and investment advisory services were outside the banks' authorized activities. Bank holding companies' activities and financial structure were limited as well.

However, underlying the Glass-Steagall Act was the legal characterization of bank acceptance of deposits as contract obligations of borrowers. Depositors obtained an IOU from their bank and banks were treated and are treated today as borrowers. Similarly, the bank lending was under a contract, with some additional bank rights.

Not surprisingly, the banks' culture in the years that followed the 1930s disaster was conservative. Many bankers served often as reliable and independent advisers to their depositors and others. They were the ultimate conservative borrowers.

Bank regulators' activities and approach reflected another aspect to the "reliable borrower" model. Presumably, in some respects, bank regulators, such as the Office of the Comptroller of the Currency, continued to believe that the more profitable business banks will engage in, the less risky banks' business will be. Therefore, the OCC, for example, continued to question the Glass-Steagall Act's limitations.

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[6] *See* Banking Act of 1933, ch. 89, Pub. L. No. 73-66, *see* 8, § 12B, 48 Stat. 162, at 168-80 (current version at 12 U.S.C. §§ 1811-1835a (2012)).
[7] *See* Investment Co. Inst. v. Camp, 401 U.S. 617 (1971) (holding that Glass-Steagall Act does not prohibit bank from pooling trust assets).
[8] *See* Banking Act of 1933, ch. 89, Pub. L. No. 73-66, §§ 16, 20, 21, 32, 48 Stat. 162, at 184-85, 188-89, 194 (codified as amended at 12 U.S.C. § 24 (Seventh), § 78 (repealed 1999), § 377 (repealed 1999), § 378 (2012)).

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Regulators pursued their approach prior to the demise of the markets in the 1930s, and continued to press for expanding the banks' financial services.[9] Moreover, throughout the years starting with the passage of the Glass-Steagall Act, and especially when the stock markets began to gain some of their former halo and trust, bank regulators pressed hard to reduce and eliminate the constraints of the Glass-Steagall Act. That pressure was finally successful in 1999. The Act was essentially eliminated.[10]

Even before the revocation of the Glass-Steagall Act, America's banks faced an internal conflict between lending officers, who were concerned with the reliability of the borrowers, and the salespersons, who were concerned with selling the banks' loans to other banks. These sales were achieved, first, by selling participations in large loans to other banks ("loan participations"). The main lender remained the lender of the large borrower, but could, as trustee to other banks, sell participations in the loans.[11]

After the demise of the Glass Steagall Act, the door was opened to bank business in brokerage, mutual funds, and various other financial services. That is when banks developed swaps in fixed interest rates with variable interest rates. Then they joined the horde of lenders who pooled the loans they held into a legal unit and caused the unit to distribute its securities representing interests in the loans and create a market in its securities. That process was entitled "securitization" and bears the name today.

However, when the banks were allowed to package the loans they made and sell them to the investors in the markets, the concern about the reliability of the borrowers was reduced. After all, the system allowed the banks to reduce their risks by both transferring the loans and by shortening the loan periods, depending on how fast they could package and sell the loans

[9] For example, a bank regulator in 1916 demanded that banks be allowed to engage in insurance business. 53 Cong. Rec. 11,001, Letter from John Skelton Williams, Comptroller, Currency, to Robert L. Owen, Chairman & Currency Comm., Senate Bank (Jul., 1916), *quoted in* Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25, at 35-36 (1996). In 1916 Congress allowed national banks in places not exceeding 5,000 inhabitants to act as insurance agents or brokers. Act of Sept. 7, 1916, ch. 461, 39 Stat. 752, at 753-54 (codified as amended at 12 U.S.C. § 92 (2012)).
[10] *See* Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, § 101, 113 Stat. 1338, at 134 (repealing 12 U.S.C. §§ 78, 377).
[11] *See* TAMAR FRANKEL, SECURITIZATION 311-521 (Ann Taylor Schwing ed., 2nd ed. 2005).

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by pooling and selling the securities of the pools in the markets. From the point of view of the law, this process helped the banks' financial reliability.

In addition to securitization, banks became engaged in collecting the payments from small borrowers (whether the borrowers were bank borrowers or the borrowers of other lenders) and paying the collected amounts to others (including banks) that acted as trustees to the securitization units.

Throughout this period and later, the view of the banks of the United States was that of lending and borrowing under contract. Banks borrowed by contract and lent by contract. Legally, a borrower is entitled to use the borrowed funds as it wishes, subject to constraints in the lending contract. Banks borrowed from depositors unconditionally. They were regulated to some extent with respect to their lending, in order to ensure that the borrowers will repay their loans. These rules could be viewed as substitutes for the lenders' conditions.

During the period of a few years before 2008, when large banks crashed, these banks were actively engaged in the securities markets and were under the bank holding companies' investors' pressure and probably insiders as well to "perform." That brought more risk. That caused at least to some extent their failure. That brought to a great extent the government's financial "bailout". That also brought the establishment of a high level committee to oversee the risk level of the banks and other large financial institutions. Thus, much has changed in the law regulating banks. What did not change was the fundamental view of bank depositors' rights. It remained a contract. What did not change was the banks legal relationship with their borrowers. This legal relationship remained contractual. The regulation of U.S. banks did not change in the sense that they were regulated in the way they could accept money, lend the money, or engage in other financial services. The change focused on the *level of risk* which the banks may take in any of these activities. Thus, the legal scheme relating to banks in the United States remained the same while the changes were made in the various parts of the scheme and the restrictions aimed at fixing the same problems that appeared in this scheme many years ago.

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When banks' services expand to other financial areas a legal-cultural problem arises. For example, the advisory service to mutual funds subjects a bank to a fiduciary relationship. This relationship conflicts with the view of the bank as providing services under a contract. Section 15 of the Investment Company of 1940 describes the relationship of the adviser to a mutual fund with the fund as contractual, but the contract is subject to unusual conditions: it cannot be transferred except under very stringent conditions, and otherwise is eliminated. Other sections of the law impose on the adviser a tremendous list of constraints subject to criminal liabilities. This contract is as far from a contract under contract law as one could imagine.

How do the bank regulators deal with these duties? It seems that they see these duties as designed to assure the bank's reputation (and presumably avoid a run by the bank's depositors or a rise in the bank's risks-which is the same). However, this approach views the law as increasing the banks' risks, which conflicts with the main purpose of bank regulation—to reduce the banks' risks.

Similarly, a bank that packages its loans and sells them in the market reduces the bank's risks and increases its returns. From this point of view the securitization of loans is a good thing. In addition, if the bank makes risky loans and packages them for public consumptions, it may still do well for the bank. Disclosure of the high risk, which the loans represent, is not necessarily beneficial to the banks. It is not surprising that the bank regulators allowed banks to transfer the loans destined for marketing into subsidiaries and the value of these subsidiaries was not calculated in the level of risk that the banks had to maintain. It was only after the 2008 crash that banks suddenly found these loans on their balance sheets, which changed the picture of their assets. Yet, the fact that the regulators allowed banks to make such loans and avoid them from joining the banks balance sheets signals the regulators' approach. They were concerned as always with the banks' safety and soundness. Presumably, safety and soundness did not involve making these loans for sale.

In sum, bank regulation in the United States is based on the assumption that the banks' contract with depositors and borrowers and that

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the risk in the banks' structure should be covered by: restrictions on risky lending and as many and as profitable financial services as they can handle, without, however, the full regulators burdens of those services. An overview of the bank regulation in the United States demonstrates that nothing has changed in this view, except the search for added sources of income and restrictions of bank risk.

4. THE DESIGN OF BANKS AND THEIR REGULATION IN JAPAN

Like United States banks, Japan's banks aim at gaining and maintaining their depositors, as well as their investors, trust and commitment. Mitsubishi UFJ Trust and Banking Corporation offers banking as well as trust services. [12]

A trust under Japanese law differs from a common law trust in that under Japanese law there is no equitable ownership. A Japanese trust is defined by statute as "an arrangement in which the owner of property rights transfers such rights to a third party on the understanding that the transferee will administer, manage and/or dispose of the property in accordance with specific guidelines established by the transferor."[13]

A trust generally must be created by an agreement, rarely by a will, and should meet statutory requirements.[14] As there is no equitable ownership, the trustee is the sole owner of the trust assets, subject to restrictions under the agreement and by statute, *e.g.*, "the trustee should not benefit from the trust assets,"[15] or "the trust assets do not belong to the trustee's personal estate,"[16] and "the trustee should not acquire any proprietary interest in the trust assets."[17]

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[12] Mitsubishi UFJ Financial Group, Inc., Annual Report (2015), *available at* http://www.mufg.jp/english/ir2015/v_c/trust_assets/ (last visited July 25, 2016).
[13] *See* Jeremy Pitts, Shinji Toyohara, & Gavin Raftery, *Expanding the Use of Trusts and Trust Banking in Japan*, INT'L FIN. L. REV. GUIDE TO JAPAN, Jan. 2004 at 75; *see also* Shinji Toyohara, Jeremy Pitts, & Gavin Raftery, *Trusts and Trust Banking*, INT'L FIN. L. REV (Jan. 5, 2004), http://www.iflr.com/Article/2026736/Trusts-and-trust-banking.html (last visited Dec. 30, 2015) (citing Trust Law [Shintaku-hou], Law No.62 of 1922, as amended).
[14] *Id.* (citing Trust Law; Trust Business Law [Shintakugyou-hou], Law No.65 of 1922, as amended).
[15] *Id.* (citing Trust Law art. 9).
[16] *Id.* (citing Trust Law art. 15).
[17] *Id.* (citing Trust Law art. 22).

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The beneficiary may be viewed to have "quasi-ownership rights" by statute, e.g., "the beneficiary can object to the attachment of the trust assets by a court in proceedings against the trustee,"[18] "the beneficiary has a right to request the return of the trust assets upon the bankruptcy of the trustee,"[19] and "the beneficiary can apply to the court to nullify a disposal of the trust assets made by the trustee in violation of the tenor and purport of the trust agreement."[20] These rights are "statutory and contractual rights against the trustee and the trust assets" rather than ownership rights.[21]

For a beneficiary to enforce these rights, the trust must be perfected. For some assets, perfection is achieved by registration; for securities, perfection is achieved by "booking in a separate account" and physical separation if possible.[22] In addition to perfection, there is an additional requirement of separation from other assets, to facilitate identification of the trust assets.[23] When third parties enter into a contract with the trustee the trustee acts as a principal, not as an agent.[24]

Only Japan-licensed trust banks may conduct trust business.[25] The permissible trust assets are "money, securities, monetary claims, moveable property, real estate and fixtures thereon and surface and land lease rights."[26]

Under a specified money (tokkin) trust, the trustor appoints a registered investment adviser to instruct the trustee regarding trust asset investments. Under a designated money (shiteitan) trust, the trustee makes investment decisions subject to the trust's investment guidelines.[27]

"[A] trustee must act in accordance with the tenor and purport of the trust agreement and with the due care of a good manager", under statute.[28]

[18] *Id.* (citing Trust Law art. 16(2)).
[19] *Id.* (interpreting Trust Law art. 16(2)).
[20] *Id.* (citing Trust Law art. 31).
[21] *Id.*
[22] *Id.*
[23] *Id.* (citing Trust Law).
[24] *Id.*
[25] *Id.* (citing Trust Law; Trust Business Law).
[26] *Id.* (citing Trust Law; Trust Business Law).
[27] *Id.*
[28] *Id.* (citing Trust Law).

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The trustee may be liable to the trustor or beneficiaries for losses caused by the mismanagement of the assets or the disposal in violation of the agreement. The trustor or beneficiaries may have a claim for indemnification or restitution. The beneficiaries may also avoid disposal to third parties in violation of the agreement if the registration or recording requirements were met, or, if not applicable, the third party knew or should have known of the violation.[29]

The trustee is personally liable for trust obligations. To protect trustees, trust agreements generally include a clause limiting recourse to trust assets (or those of the trustee's other trusts) and an indemnity provision. To protect third parties, where there is limited recourse, there is generally a negative pledge clause to prevent the trustee from impairing the assets. In addition, the agreement often provides that limited recourse does not apply in case of certain misconducts by the trustee.[30]

With a specified money trust, the issue arises of whether the adviser may bind the trustee. This authority is determined by the trust agreement. Third parties should confirm that the adviser has binding authority. The agreement may also determine to whom the third party has recourse on default.[31]

In 1999, Japan authorized master trusts, which are used in securitization.[32] In 2000, Japan authorized JReits (real estate investment trusts).[33] Trusts have also been used to offer beneficial interests in reorganization claims.[34]

As of 2004, Japan was considering reforms including (1) expanding the classes of permissible trust assets[35] and (2) establishing three categories of trust business license with different requirements, for (1) passive trusts

[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id.* (citing amendments to Law Concerning Investment Trusts and Investment Companies (Investment Trust Law)).
[34] *Id.*
[35] *Id.* (proposing amendment to Trust Business Law).

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(where the trustee has no discretion), (2) securitization trusts, and (3) active trusts (where the trustee has discretion).[36]

The law in Japan does not impose on Japanese banks fiduciary law but this Japanese Bank has decided to self-impose fiduciary law on its activities not only in Japan but also on its subsidiaries abroad, including the New York subsidiary

The important aspect of this Bank is its initiative. It expands its legal duties and its president and management have committed to instill in its employees the culture and principles of fiduciary principles and law, where its employees view themselves as trustees with respect to their services and their control over other people's money. This is a process which started about in 2011 and is taking shape and power currently, in 2015.[37]

5. TRUST-BASED BANKING LAW IN ISRAEL

Banking law in the State of Israel imposes fiduciary law on banks. There are no "ifs" and "buts" about it. The law is clear and the rules are similar to trust law. In any banking system, depositors hand their money to the bank. However, in Israel banks hold their depositors' money *not as obligors but as fiduciaries, similar to trustees*.[38] The banks' obligations to their depositors are not contractual obligations. They are trustees' obligations. Terms of the trusts are spelled out in the law and regulated and enforced by the government. They are not left to negotiations with the depositors nor are they left to disclosure about the use of the depositors' money. The banks may lend money to borrowers. But, again, they do that as trustees. They are subject to prohibitions of conflicts of interest, and to the duty of care, which is detailed by legislation and rules. The culture in Israel's banks reflects its

[36] *Id.* (proposing amendment to Law Concerning the Concurrent Undertaking of Trust Business by Financial Institutions (Kin'yuukikan no shintakugyoumu no ken'ei-tou ni kan-suru houritsu), Law 43 of 1943, as amended).
[37] *See generally* Trust Assets Business, MUFG Report 2015,
http://www.mufg.jp/english/ir2015/v_c/trust_assets (last visited May 23, 2016).
Mitsubishi UFG Financial Group, Inc., *Trust Assets Business*, *available at* http://www.mufg.jp/english/ir2015/v_c/trust_assets/ (last visited May 2, 2016).
[38] Ruth Plato-Shinar, *An Angel Named 'The Bank': The Bank's Fiduciary Duty as the Basic Theory in Israeli Banking Law*, 36 COMM. L. WORLD REV. 27, at 33 (2007).

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governing laws. When one is, for generations, called and expect to behave as a trustee one become a trustee and act as one.

6. CONCLUSION: FOOD FOR THOUGHT

A business regulated under contract law usually deals with people, who can fend for themselves. In fact, in the United States the sale of many goods (exchanging the goods for money) is accompanied by the buyer's option of rescinding the sale under certain conditions. This is a form of guarantee by the seller assuring the buyer that the seller's promises (and even the seller's sales persons who might have induced a sale) are truthful and trustworthy. Thus, control in those transactions is balanced between the parties.

In the case of financial services, however, control is not balanced, but shifts to the "seller" of the services (accompanied by control over the "buyer's" money). The government's backing of banks' obligations may reduce the depositors' anxiety but it increases the bank management and personnel's drive to gain more and inevitably, risk more. Hence, fiduciary law and its accompanying duties are more appropriate for banks, and would be far more effective by providing banks with more safety and becoming more trustworthy. In all cases, the law introduces bank cultures. While contract culture tends to justify self interest fiduciary culture tends to balance the parties interests. Thus, regulation that tends to impose on banks self-limitations as trustees might reduce the banks' risks and benefit the financial system.

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The New Round of Civil Law Codification in China

XIANCHU ZHANG[†]

TABLE OF CONTENTS: 1. An Introduction; 2. Path of Civil Law Codification in China; 3. Political Difficulties; 4. Doctrinal Debates Over Civil Law Codification; 5. Further Implications of the Civil Law Codification; 6. Conclusion.

ABSTRACT: Despite a long unsuccessful history, civil law codification has entered into a new stage in China in 2014 when the Central Committee of the Communist Party (CCP) made its call for this compilation in its Decisions on Major Issues Concerning Comprehensively Moving Governing the Country According to the Law Forward (2014 Decisions) for the first time since the establishment of the People's Republic of China (PRC).[1] Although the political promotion may be welcomed as an encouraging sign of the Party-State's commitment to the rule of law development in China's social and market transition, the codification is still facing a wide range of challenges, ranging from political ideology to technical controversies. This article critically examines the background of the new round of codification, the progress made thus far and some major issues that have been heatedly debated. It is argued that in terms of the path for civil and private law development China may take no exception to other developed market economies with profound political and institutional reform.

KEYWORDS: *China; Civil Code; Institutional Reform; German Code; Commercial Law.*

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[1] The CCP Decision was adopted on 30 Oct. 2014 by the Fourth Plenary Session of the 18th Communist Party of China Central Committee. An English translation is available at https://chinacopyrightandmedia.wordpress.com/2014/10/29/explanation-concerning-the-ccp-central-committee-decision-concerning-some-major-questions-in-comprehensively-moving-governing-the-country-according-to-the-law-forward/.

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1. AN INTRODUCTION

A historical economic reform with an open-door policy began in China in the late 1970s and has changed the country significantly. China has become the second largest economy in the world and is expected to surpass the United States within a short period. With per capita GDP of $8018 reached in 2015, China is entering into a middle class society. The rise of China has become a phenomenon in the new century and has had a profound implication on the entire world. [2]

Although today China is still a socialist country economic reform and opening policy have dramatically weakened and reduced the Party-State control, particularly in respect of growth and the quality of economic life. Since the Constitutional Amendment in 1993 where the traditional planned economy was officially replaced with the so-called "socialist market economy,"[3] a legal status of private economy as its important part has eventually been recognized.[4] China's accession to the World Trade Organization (hereinafter WTO) in 2001 further improved the market access and competition conditions. In terms of business ownership structure, according to a recent statistical survey, by the end of 2013 private enterprises and commercial households reached 12.53 million and 44.36 million respectively making their contribution to more than 60% of the national GDP.[5] On the contrary, the number of the state-owned enterprises (hereinafter SOEs) has dropped to approximately 155,000, although they are still very powerful in terms of scale and in holding their monopolistic positions in all the key business sectors of the country.[6]

Meanwhile, more and more private and civil rights have been recognized in legislation and judicial practice in rapid social and economic

[2] The World Bank [WBG], *China 2030: building a modern, harmonious and creative society,* (Washington,DC:WorldBank,2013);http://www.worldbank.org/content/dam/Worldbank/document/China-2030-complete.pdf; and Andrew Soergel, "America's Days Are Numbered as the World's Top Economy", *US News and World Report*, (Dec. 28, 2015).
[3] The Constitutional Amendments of 1993, Art. 7.
[4] The Constitutional Amendments of 1999, Art. 16.
[5] *Private Sector's Contribution to More Than 60% of the National GDP in 2013*, XINHUA SHE (Feb. 28, 2014).
[6] *Disclosure of State Owned Enterprises: Less Than 1% in Number with More Than 30% of Total National Assets*, ZHONGGUO CHABJING XINWEN BAO [INDUSTRIAL AND ECONOMIC JOURNAL OF CHINA], July 31, 2014.

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developments. At the legislative level, the Chinese Government declared in 2011 that after the reform for more than 30 years a new legal system with Chinese characteristics had been established with civil and commercial law as one of its major components where more than 33 national laws and numerous government regulations had been adopted in this regard. [7]

With respect to the judicial practice beyond the traditional civil law, many new types of litigation have reached the People's Court even prior to the relevant laws being enacted or updated, such as disputes related to e-commerce, corporate social responsibility, shareholders' derivative actions, use of computer software, telecommunication services, right to education, damages to mental health and personality rights, employment discrimination, antimonopoly and consumer protection, land requisition, and production rights. In order to the streamline handling of civil cases, the Supreme People's Court (hereinafter SPC) promulgated its first Provisions on Causes of Civil Actions (on trial basis) in 2000 with 300 types of civil cases stipulated in four categories. The Provisions were further revised and dramatically expanded in 2008. The current version promulgated in 2011 includes 424 causes of civil action classified into ten categories, which are further divided into forty-three sub-categories. Contract related disputes alone (which include intellectual property contracts) count for seventy-five different types of claims.[8]

Moreover, the SPC has issued a large number of judicial interpretations and policies in order to remedy the situations where the laws were either lacking, or not clear and detailed enough.[9] Since 2011 the SPC has further developed its guiding case system, where cases with guiding value are selected by the SPC and promulgated for the lower courts to follow in

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[7] Info. Office of the State Council of the China, *The Socialist Legal System with Chinese Characteristics* (Oct. 27, 2011), http://www.china.org.cn/government/whitepaper/node_7137666.htm.

[8] Ten major categories of the Provisions on Causes of Civil Actions of 2011 include cases related to personality rights, marriage and family rights, property rights, contract rights, intellectual property rights, labor rights, maritime disputes, enterprises disputes, tort claims, and civil capacity and litigation rights. *See*, for an English translation and comments, YILIANG DONG, HONGYAN LIU, KNUT B. PIẞLER, THE 2011 REGULATION ON THE CAUSES OF CIVIL ACTION OF THE SUPREME PEOPLE'S COURT OF THE PEOPLE'S REPUBLIC OF CHINA (2011).

[9] *See* Law on Legislation (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 15, 2015, effective Mar. 15, 2015) (amending Law on Legislation (2000)), ch. 6, art. 104, 2015 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).

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their adjudications. By the end of 2015, fifty-six guiding cases have been adopted with more than half being civil or commercial decisions.[10]

To a large extent, such developments are much needed in order to respond to the rapid social and economic changes taking place in China and the increasingly intensified conflicts in this transition. As the largest developing and socialist country in the world, China's social and economic transition to a rule of law society and a market economy is susceptible to large scale and tempestuous clashes between different interest groups, social classes and old and new institutions. Such conflicts have not only made China become "one of the most litigious" societies in the world,[11] but produced a large number of "mass incidents" referring to planned or impromptu gatherings in forms of public speeches, demonstrations, public airings of grievances, or even violent attacks on government organs, factories or other property as means to protest against the abuse of power, corruption, an underdeveloped social welfare system, and a lack of applicable legal remedies that are seen as disrupting social stability and direct challenges to the current Party-State regime.[12] According to some academic surveys, the number of reported "mass incidents" rose from 8,700 in 1993 to more than 90,000 in 2006, and further up to 180,000 in 2010.[13]

From this reflection it has become evident that the existing laws and their enforcement cannot really keep up with the country's social and economic development and effectively prevent and settle the rapidly increasing number of civil disputes and social conflicts. Against this background, codification of civil law has become a hot topic in China again

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[10] For a detailed analysis of the guiding case practice see MEL GECHLIK, *China Guiding Cases Project*, Issue No. 4, CGC.LAW.STANFORD.EDU (May 1, 2015), https://cgc.law.stanford.edu/guiding-cases-analytics/issue-4/.

[11] Tom Phillips, *China Will Be 'One of the Most Litigious' Countries in the World*, INTELL. PROP. MAG., Dec. 6, 2013. According to the latest working report of the Supreme People's Court, the judiciary of China at all the levels received more than 15.51 million lawsuits in 2015, or more than 20% increase from the previous year, with over 75 % being civil and commercial cases. Report, Takeaways from the Supreme People's Court 2015 Work Report, *Supreme People's Court Monitor* (Mar. 15, 2016), https://supremepeoplescourtmonitor.com/2016/03/15/takeaways-from-the-supreme-peoples-court-2015-work-report/.

[12] Tao Ran, *China's Land Grab Is Undermining Grassroots Democracy*, THE GUARDIAN (London, Dec. 16, 2011)https://www.theguardian.com/commentisfree/2011/dec/16/china-land-grab-undermining-democracy; and Austin Strange, *Mass Incidents in Central China: Causes, Historical Factors, and Implications to the PAP*, 17 THE MONITOR 32 (2012).

[13] Barbara Demick, *Protests in China over Local Grievances Surge, and Get a Hearing*, L.A. TIMES (Oct. 8, 2011) http://articles.latimes.com/2011/oct/08/world/la-fg-china-protests-20111009.

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since 2014 due to the direct promotion of the CCP made for the first time in the history of the PRC. Although the political decision has provided the codification with new momentum, the enactment in China as a socialist market economy is still facing some major political challenges and doctrinal uncertainties.

2. PATH OF CIVIL LAW CODIFICATION IN CHINA

In terms of legal tradition China has long belonged to the civil law family with embodiment of legal principles and rules into codes as the most reliable sources of law. Historically, the practice to codify legal rules through a public way can be traceable to Spring and Autumn and the Warring States Periods (BC 770–221) and codification in Tang Dynasty was considered "the foundation on which the Chinese legal system was built from the 7th till the beginning of the twentieth century."[14] However, it should be noted that in the long feudal history almost all the laws were of public nature resulting in punishment if commercial activities were obstructed. As a result, "[t]he concept of 'civil' or 'private' law did not exist."[15]

In the reformation period of Qing Dynasty some basic laws were introduced from the West and eventually became the first attempt of modern legislation in China, which included both Draft Civil Law and Commercial Law modeled after the codes of Germany and Japan. After the 1911 Revolution the Nationalist Government promulgated the first Civil Code in China's history in 1930, which also followed the style of the German Civil Code (Bürgerliches Gesetzbuch, BGB) due to the influence from Japan. However, a controversy emerged in the legislative process on the system design of civil and commercial law codification. Finally, a decision was made by the Central Political Committee of Kuomintang (Chinese Nationalist Party) to combine general rules of civil and commercial laws into a unified code with

[14] Ping-Sheung Foo, *Introduction* to THE CIVIL CODE OF THE REPUBLIC OF CHINA, *at* iv (Ching-Lin Hsia, James L. E. Chow, Yukon Chang trans., 1930).
[15] Edward Epstein, *Codification of Civil Law in the People's Republic of China: Form and Substance in the Reception of Concepts and Elements of Western Private Law*, 32 *U.B.C. L. REV.* 153, 162 (1998); and Max Weber, *Economy of Law or Sociology of Law, in* 2 ECONOMY AND SOCIOLOGY: AN OUTLINE OF INTERPRETIVE SOCIOLOGY (Claus Wittich ed., 1978).

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subordinate supplementary laws, such as Company Law, Commercial Paper Law, Insurance Law, and Bankruptcy Law, to deal with specific fields.[16]

The establishment of a socialist government in 1949 led to not only complete abolition of the legal system of the Nationalist Government, but also to a domination of the Soviet style planned economy for more than three decades. Since then although it has been a long desire of the top leaders and scholars to eventually develop a comprehensive civil code on a grand scale in China, four rounds of civil law codification have failed so far. The attempts to develop a civil code with some preliminary drafts in the 1950s (1954-1956) and 1960s (1962-1964) were short lived because of the political conditions at the time. The planned economy and class struggle apparently did not allow any chance for a civil code to come to frutition.[17] Although the efforts produced some progress, including two drafts of Civil Law being completed in 1956 and 1964 modeled after the former Soviet Union Civil Code of 1922, legislative process was disrupted due to the hostile political movements and ideology against private rights and autonomy. Despite the political hostility, from an academic perspective Roman law and *Pandektenrecht* continued to be modeled in certain legal studies and legislation.[18]

The third round of codification was not initiated until the late 1970s after economic reform and open door policy were implemented. Although two drafts with more than 460 articles were worked out, the political uncertainties in the early years of reform and insufficient experience and theoretic preparation rendered the further progress impossible. As a result, the drafting group was dissolved by the Standing Committee of the National People's Congress (hereinafter NPC) as the top national legislature in 1981. Instead, the General Principles of Civil Law (hereinafter GPCL) was eventually promulgated in 1986 as an interim solution to meet the urgent needs of social and market development of the time. One the one hand, the GPCL laid down an important foundation for private law development in China with its explicit stipulation for the first time in the PRC history that

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[16] Tsung-Fu Chen, *Transplant of Civil Code in Japan, Taiwan, and China: With the Focus of Legal Evolution*, 6 NAT'L TAIWAN UNIV. L. REV. 389, 398-401 (2011).
[17] Liming Wang, *The Systematization of the Chinese Civil Code*, in TOWARDS A CHINESE CIVIL CODE: COMPARATIVE AND HISTORICAL PERSPECTIVES 21, 24 (Lei Chen, Cornelis Hendrik Van Rhee eds., 2012).
[18] *Id.* For some detailed discussion on the drafts made in this period see Epstein, *supra* note 15, at 153-198.

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the law shall govern property relations among the subjects with equal legal status.[19] It has not only provided the economic reform and market development with urgently needed rules and guidelines, but also laid a foundation to develop a civil and commercial law system in China. As Professor Wang Liming of the People's University pointed out, promulgation of the GPCL marked a new stage of developing and systematizing civil and commercial legislation in China.[20]

On the other hand, it was an immature product where the drafting process was guided by the principle of "general rather than detailed" to deal with urgent practical demands without sufficient experience and doctrinal preparation immediately after the ten year disastrous "Cultural Revolution". As Peng Zhen, then Vice Chairman of the NPC, stated, "It is impossible to adopt a civil law within a short period. This is not because we are not working hard enough, but the issues concerned are so complicated and many problems have not been settled in the economic reform."[21]

As a result, the current civil and commercial system has been developed on the basis of the GPCL of 1986, which includes nine chapters and 156 articles covering the general principles, citizens (natural persons), legal persons, civil juristic acts and agency, civil rights, civil liability, statutory limitation, application of law in foreign related civil relations, and miscellaneous provisions. Two main features reflected in the structure and contents of the GPCL are that (1) it follows the German *Pandekten* or Roman Digest System, where general principles are set out first followed by separate provisions applicable to specific legal areas; and (2) it combines civil and commercial rules in a single legislation. In addition to general rules to deal with civil law matters, the GPCL stipulates provisions governing individual commercial households, enterprise legal persons, business joint operation, contract, intellectual property rights, civil liabilities including damages

[19] General Principles of the Civil Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987), ch. 1, art.2 (1986).
[20] Wang, *supra* note 17.
[21] Quoted from Liang Hui Xing, Professor of Inst. of Law of Chinese Acad. of Soc. Sci., *Revisited Certain Issues in Civil Law Codification with Response to De-codification* (Mar. 24, 2015), http://www.aisixiang.com/data/90909.html.

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arising from tortious conducts, product liability and breach of contract, and foreign related disputes.[22]

Although from today's view the GPCL may not be considered consummate, as the first comprehensive private law enactment in the PRC its significance should not be underestimated. Thus far major civil/private laws adopted on the basis of the GPCL include Marriage Law (as amended in 2001), Tort Liability Law (2009), Contract Law (1999), Law on Right *in rem* (2007), Company Law (as amended in 2013), Partnership Enterprises Law (as amended in 2006), Sole-proprietor Enterprises Law (1999), Commercial Bank Law (as amended in 2015), Commercial Bank Supervision Law (2006); Security Law (1995), Securities Law (as amended in 2014), Securities Investment Fund Law (as amended in 2012), Trust Law (2001), Maritime Law (1992), Commercial Paper Law (as amended in 2004), Insurance Law (as amended in 2015), Patent Law (as amended in 2008), Trade Mark Law (as amended in 2013), Copyright Law (as amended in 2010), Enterprises Bankruptcy Law (2006), Sino-Foreign Equity Joint Venture Law (as amended in 2000), Sino-Foreign Cooperative Joint Venture Law (as amended in 2001), Wholly Foreign Owned Enterprises Laws (as amended in 2001), and Governing Law Applicable to Foreign Related Civil Relations (2010). Many laws have borrowed rules from international treaties and experiences of developed economies. Some of them have been amended two or three times since their first adoption in order to deal with the new developments and catch up with worldwide competition.[23] As such a legislative pattern to include civil and commercial laws in one category on the basis of the GPCL, have been followed in the past thirty years.

The fourth round of codification was resumed in late 1998 after the historical Constitutional Amendments where the planned economy was officially given up and replaced with the "socialist market economy" in 1993.[24] According to the working plan, a civil code would be developed by three steps: first, adopt a uniform contract law by 1999; second, adopt a

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[22] An English translation of the GPCL is available at the NPC's website, at http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content_1383941.htm.
[23] Shiyuan Han, *Civil Law Codification in China: Its Characteristics, Social Function and Future*, *in* CODIFICATION IN EAST ASIA 201, 210-211 (Wen-Yeu Wang ed., 2014).
[24] Art. 7 of the Constitutional Amendments of 1993.

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uniform property law; and finally, complete enactment of the Civil Code by 2010. China's accession to the WTO in 2001 provided the legislative process with new momentum and pressure as the top leaders of the NPC asked the drafting group to accelerate its work and to complete its first draft Civil Code in 2002. Although the first draft indeed managed to be submitted to the national legislature for review on 17 December 2002 (2002 Draft Code),[25] the acceleration was apparently hindered with difficulties and poor draftsmanship.

The 2002 Draft Code included more than 1200 articles in nine parts, including the General Principles, Property Law, Contract Law, Rights of Personality, Marriage, Adoption, Succession, Tort Liabilities, and Governing Law Applicable to Foreign Related Civil Relations.[26] As some scholars observed, under the time pressure the 2002 Draft Code was not a fine work at all, but just a rough product to piece together existing legislations without decent digestion. Since the legislators could not find a good basis to carry out their deliberation to build up any legislative consensus, the first reading of the Draft Civil Code triggered extensive controversies, even among the key members of the drafting group.[27] Such premature promotion has left negative impacts on the legislative process. Since 2002 the drafting of the civil code fell to a standstill until a new call was made by the CCP recently.

Unlike the previous rounds where the enactment efforts were initiated by the legislature subject to the CCP's political approval, the current codification is directly launched by the CCP itself. The new leadership, after being appointed in late 2012, unleashed a campaign to deepen institutional reforms in order to deal with the country's economic upgrading and challenges in its transition toward a moderately prosperous society. On the 12th of November 2013 the CCP adopted its Decision on Major Issues Concerning Comprehensively Deepening Reforms with a pledge to "let the

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[25] *China's First Draft Civil Code Submitted for Review,* PEOPLE'S DAILY (Beijing, Dec. 24, 2002) http://en.people.cn/200212/23/eng20021223_108978.shtml.

[26] An English translation of the draft code is available at THE LEGISLATIVE RESEARCH GROUP OF THE CHINESE ACADEMY OF SOCIAL SCIENCES, THE DRAFT CIVIL CODE OF THE PEOPLE'S REPUBLIC OF CHINA (Huixing Liang ed., 2010).

[27] Qingyu Zhu, *The Code Rationale and General Principles of Civil Law: Thoughts on Civil Law Codification in Mainland China*, 22 PEKING U. LAW J. 485 (2010).

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market play a decisive role".[28] Soon after the CCP promulgated the 2014 Decisions where civil law codification was explicitly called as part of efforts to better protect citizens' rights and safeguard market development.[29]

The Standing Committee of the NPC quickly made its response to the CCP assignment by including the civil law codification into its amended five year legislative plan for 2013-18.[30] Under the plan, the codification will be divided into two stages with the first one to formulate the general principles of the civil code, followed by comprehensive integration of all the civil/commercial legislations into the code.

According to a report published by the Hong Kong Commercial Daily a Draft of General Principles with 186 articles as the first book of the Civil Code (hereinafter Draft Principles) has been completed[31] and submitted to the Standing Committee of the NPC for its first deliberation on 27 June 2016, followed by a public consultation period of one month. The target was set with the intention of adopting the General Principles in March 2017 and completing the entire compilation by March 2020.[32]

3. POLITICAL DIFFICULTIES

The renewed efforts for civil law codification should certainly be welcome as a positive sign of further modernization of the national legal system. However, given China's present political foundation, the legislation may have to first deal with some political obstacles.

In China the Constitution as the supreme law of the country does not stipulate a basis for the equal right entitlement because public ownership and the state economy have been provided with the constitutional guarantee

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[28] An English translation of the Decision is available at http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602.htm.

[29] CCP Decision (2014), *supra* note 1, part 2(4).

[30] *China Includes Civil Law Codification in Legislation Plan*, GLOBAL TIMES (Beijing, Aug. 5, 2015) http//www.globaltimes.cn/content/935674.shtml.

[31] *China Drafting Civil Code: Spokeswoman*, XINHUA SHE (Mar. 4, 2016), http://news.xinhuanet.com/english/2016-03/04/c_135155512.htm. The Proposed Draft is available at http://www.civillaw.com.cn/zt/t/?30198 (in Chinese).

[32] *The Civil Code Is Taking Shape by 2020*, HONG KONG COM. DAILY, June 28, 2016.

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for their sacred and inviolable status as the leading positions,[33] whereas the private sector may only be an important component of the socialist market economy subject to government administration and supervision.[34] Although the Constitution finally recognized private property inviolable in 2004 under strong demands, it has still refused to grant it the same legal status of sacredness.[35] As a result, codification of civil law may not advance equal right protection further unless some breakthroughs can be made at the Constitutional level.

Such a political environment has directly affected private law development. In 2005 the national legislature was stunned in its intended final round deliberation of the Law on Rights *in rem* by more than 11,000 submissions nationwide and in particular, an open letter from a constitutional law professor of Peking University with supports from 700 officials and scholars to question the constitutionality of the enactment in violation of the fundamental principles of socialism. The political debate rendered a long delay of the legislation until it was finally passed in March 2007 with an explicit provision for safeguarding the country's fundamental economic system.[36] In a more recent incident, the State-Owned Assets Supervision and Administration Commission (hereinafter SASAC) as a state department and the mega-shareholder in charge of SOEs' operation strongly opposed the further SOE reform proposals urged by the World Bank in its study report by accusing them of being in violation of the Constitutional principles on public ownership guarantee with an attempt to overturn the socialist system in China.[37] In the new round of SOE reform initiated by the CCP in 2013, the major theme has been changed from breaking the SOE

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[33] *See* Art. 6,7 and 12 of the Constitution of PRC.
[34] *Id*. art. 11.
[35] *See* Art. 22 of the Constitutional Amendments of 2004.
[36] *See* Law on Rights *In Rem* (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), pt. I, ch. 1, art. 1, 2007 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China). For a more detailed discussion see JIANFU CHEN, CHINESE LAW: CONTEXT AND TRANSFORMATION 375-377 (2008).
[37] The World Bank [WBG], *supra* note 2. For a comment on the SASAC's behavior and approach see Barry Naughton, Leadership Transition and the 'Top-Level Design' of Economic Reform, *China Leadership Monitor*, (N. 2012-37, 2012), http://www.hoover.org/sites/default/files/uploads/documents/CLM37BN.pdf.

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monopoly and improving the level playing field to making SOEs "larger and stronger".[38]

Such legal inequality has been widely reflected in practice. For instance, in recent years as many as 570,000 violent demolition cases were reported to the state authorities with many casualties in government-led real property development nationwide, even after the State Council tried to stop the violations with its regulation on land taking in 2011 mandating fair compensation and judicial intervention.[39]

Against this backdrop, some scholars have raised the question whether the Civil Code should be established on the basis of the current Constitution. In a normal logic such legal hierarchy may not be ever doubted; but in China the linkage and reliance would mean the extension of the political ideology of the Constitution to the equal footing arena of civil law. Professor Long Weiqiu of Beijing Aviation University recently argued that according to legal history civil law was developed before the evolution of the constitution. Despite its higher status, the Constitution, in addition to political right stipulation, should also respect the civil law demands. This has been evident from the development of Civil Codes in France, Germany and Switzerland as the leading civil law jurisdictions where the Constitution is not necessarily relied on because the political and civil rights should be treated relatively separately.[40] Some scholars disagreed. For instance, Professor Wang Yi of the People's University held that the Constitution should be the legal basis of the Civil Code, although it may not be the direct source of private law and adjudication. He further advocated reflection of the Marxist philosophy in the civil codification.[41]

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[38] *See* WANG LAN, *What the Constitution Says about the SOE Reform*, ENGLISH.CAIXIN.COM (Sept. 21, 2015), http://english.caixin.com/2015-09-21/100853814.html; and EAST ASIA FORUM, *SOE Reforms in China Go the Communist Party's Way*, ECONOMYWATCH.ORG (Oct. 28, 2015), http://www.economywatch.com/features/SOE-Reforms-in-China-Go-the-Communist-Partys-Way1028.html.

[39] Fang Chen, Libin Wang, and Junhui Ling, *High Incidence of Land Disputes: Huge Profits behind Violent Demolition*, *JINGHUA SHIBAO* (BEIJING DAILY), Aug. 4, 2014.

[40] LONG WEI QIU, *Civil Codification Should Be Alert on the Trap to Base on the Constitution*, AISIXIANG.COM (Mar. 22, 2016), http://www.aisixiang.com/data/98003.html.

[41] Wang Yi, Professor, Jinan Univ. Sch. of Law, Talk on Civil Codification (Jun. 5, 2015), http://law.jnu.edu.cn/Show.asp?C-1-1309.html.

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Another serious debate reflecting the ideological struggle is on personality rights. One school led by Professor Wang Liming of People's University, a key member of the national legislature, has enthusiastically advocated for setting out a special book in the Civil Code to be developed for protection of such rights, including rights to life, health, name, fame, creditability, portraiture image, privacy, personal information and personal freedoms. The Civil Law Study Association of China as an academic group has completed its Draft Principles for consultation and discussion.[42] According to Wang, the special book is needed for better protection of human rights and other fundamental citizens' rights, particularly in the electronic era as a reflection of the trend of civil law development to remedy the defective structure of traditional civil law with much more emphasis on property rights protection over personal rights.[43]

This view has been met with strong opposition. For example, Professor Yin Tian of Peking University believes that such expansion of personality rights may lead to a lot of legal uncertainties whereas tort law should be able to provide sufficient legal remedies to personality right violations. As a result, the special book is of no practical value as long as the relevant rights are recognized in the general provisions of the Civil Code to be adopted.[44] Many more others have also raised their concerns from a technical perspective, such as optimal structural arrangement and rational coordination with other provisions of the civil code.[45]

Thus far the fiercest criticism has come from Professor Liang Huixing of China Social Science Academy who took the debate to a political level. According to him, the Ukrainian civil codification in 2003 where personality rights was set out in a special book is the only case thus far worldwide. Besides the academic controversies, he further blamed the personality rights codification for country's color revolution, national division, and domestic

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[42] *See* XINHUA SHE, *supra* note 31.
[43] *See* Wang, *supra* note 17, at 25-26.
[44] Tian Yin, *More Criticism to a Special Section on Personality Rights in Civil Codification of Personality Rights in Civil Codification: Scope of Civil Law Protection*, BIJIAOFA YANJIU [J. OF COMP. LAW], no. 6, 2015, at 1-7.
[45] Discussion Summary of the Conference on Civil Codification of Personality Rights at Zhongnan University of Economics and Law (Aug. 2, 2015),
http://www.privatelaw.com.cn/Web_P/N_Show/?PID=10619.

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disorder by allowing too much civil rights. He even made a call for not following the Ukrainian experience for more social liberalization.[46] The latest incidents with significant impacts on the civil codification and challenges to the current legal regime are the renewal of land use right after the original term has expired. In China, since all the urban lands are owned by the state, housing owners may only be entitled to the right to use the land concerned for a certain period of time.[47] However, the existing laws conflict on the renewal of land use rights. According to the Law on Rights *in rem* of 2007 as the later legislation with higher legal authority, "the right of land use shall be automatically renewed upon the expiration of the original term."[48] However, Art. 22 of the Urban Real Estate Administration Law, which was originally adopted in 1994 by the Standing Committee of the NPC, stipulates that an application must be filed at least one year before the term expiration for the government approval with payment of new fees, if the user wants to continue to use the land; otherwise the land use right shall be returned to the State without any compensation. In April 2016 some local governments' demand for payments of high fees to renew the land use rights by the land rights holders has triggered a fierce debate nationwide. Some scholars argue that "automatic renewal" not only means renewal without any conditions from legal interpretation, but more importantly matters with citizens' basic rights guaranteed by the law.[49] Apparently this type of problems may not be settled soon and may complicate the civil codification with both legal and political implications.

Directly related to these political controversies, scholars are further divided on the progress of the codification. Some experts held their opinions

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[46] Liang H. X., Professor, Inst. of Law of Chinese Acad. of Soc. Sci., *Certain Legislative and Theoretical Issues Concerning General Principles of Civil Law* (Oct. 15, 2015), http://m.aisixiang.com/data/93139.html.
[47] *See* Art. 10 of the Constitution of the PRC. See also Urban Real Estate Administration Law (promulgated by the Standing Comm. Nat'l People's Cong., Sep. 23, 2012, effective Sep. 23, 2012) (amending Urban Real Estate Administration Law (1994)), ch. 2.1, art. 8, 2012 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).
[48] *See* Law on Rights *in rem* (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), pt. III, ch. 12, art. 149, 2007 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China). The Law has higher legal authority because it is one of the basic laws of the country adopted the full session of the NPC rather than its Standing Committee as its executive organ.
[49] Yu Ji , Yuan Bo, *Any More Fees to Pay by Residents upon the Term Expiration?,* RENMIN WANG [PEOPLE'S DAILY ONLINE], (Beijing, Apr. 19, 2016), http://politics.people.com.cn/n1/2016/0419/c1001-28288644.html.

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firmly to idolize civil code and advocated for avoiding "unnecessary debates" in order to complete the codification within a time not too long" because civil code represents the highest level of legislative achievement and maturity of a legal system. To them, the CCP's decision has provided the course with "a strong political guarantee."[50] Other scholars took a much more cautious view by pointing to the lessons from the previous failed attempts and the fact that half of the 156 provisions of the current GPCL alone have been either outdated, or replaced by other legislations. As a result, the institutional evolution to be needed will inevitably make "the codification a very difficult process." To them, whether the legislative condition is ripe remains a question.[51] Some even predicted the need of at least from five to eight years to complete the compilation.[52] Long further pointed out, in a sense civil codification is a political process; but thus far unlike the civil codifications in rise of Germany and France with unambiguous political aspiration to build up a civil society, the CCP has not clearly defined the political ideal of the legislation, except just one sentence call.[53]

4. DOCTRINAL DEBATES OVER CIVIL LAW CODIFICATION

Against the political complexity reflected above, the limited space of this article would not be a suitable place to examine all the issues that have been raised and debated in the course of civil codification in China. Instead, some major concerns will be summarized and reflected in a sketch way.

(1) Path of civil law codification. In general, there are four major schools debating on the path of civil codification. Liang holds that China should stick to the traditional style and structure of the BGB with necessary adaptation according to the Chinese conditions. He places great emphasis on China's civil law development path to follow the German BGB and its logic

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[50] Jingwei Liu, *Discussion on Certain Issues Concerning the Civil Codification in China,* ZHONGGUO GAOXIAO SHEHUI KEXUE [SOCIAL SCIENCE OF HIGHER EDUCATION OF CHINA], no. 2, 2015, at 145-155.
[51] Wei Xiao, *Is the Civil Codification Ready This Time?*, BEIJING SHANGABAO [BEIJING BUSINESS TODAY], Dec.19, 2014.
[52] *The General Principles Shall Not Miss 'The Objects of Rights'*, FAZHI RIBAO [LEGAL DAILY], Mar. 22, 2016.
[53] LONG W. Q., Dean & Professor, Beihang Univ. Law Sch., *Key Issues in Civil Codification in China* (Oct. 26, 2015), http://www.cnchinese.com/html/redian/201510265824.html.

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system.[54] Other scholars even claimed that the German style had become a tradition of Chinese civil law jurisprudence and thus "we have to adopt the system of German Civil Code."[55] Professor Jiang Ping of China University of Political Science and Law, a leading authority of civil and commercial law in China, prefers a more liberal and pragmatic approach. According to him, legal relations today have been rapidly developed to a level so complex that it would be impossible to effectively regulate them by the traditional civil law. As a result, civil law codification should not be exclusively based on the German Code and others' good experiences, including common law jurisdictions, should also be accommodated as much as possible. He argues for a breakthrough of China's traditional path with heavy reliance on the German model.[56]

A school led by Wang seems to try to find a midway but with a higher goal. He agreed with Professor Jiang on the breakthrough position, but has advocated for an approach to codify civil laws principally on the basis of the structure and experience of BGB with structural modifications to reflect Chinese characteristics and to develop a Chinese civil law with important impacts on the world, or even surpass the BGB and Code Napoléon. [57] In this regard, Wang has vigorously advocated for enhancement of protection of personality rights in China's civil codification by proposing a new book on personality rights in addition to the BGB structure.[58] In addition to the GBG-centered debates Professor Xu Guodong of Xiamen University advocates for a more French style codification with a primary stress on person and personal relations in the code to be adopted. He even labels his legislative approach

[54] Huixing Liang, *Three Thinking Paths on Civil Codification,* LVSHI SHIJIE [LAWYERS' WORLD], no. 4, 2003, at 4-5.
[55] Jing-Wei Liu, *Two Basic Problems Need to Be Settled in Civil Law Codification*, in MAIRU 21 SHIJI DE LIANGAN SIFA [APPROACHING TO CROSS STRAIT PRIVATE LAW IN THE 21ST CENTURY] 125-146 (2004).
[56] Ping Jiang, *Adopting An Open Civil Code*, ZHENGFA LUNTAN [TRIBUNE OF POLITICAL SCIENCE AND LAW], no. 2, 2003, at 115-116); and Ping Jiang, *Civil Law: Retrospective and Prospective*, BIJIAOFA YANJIU [JOURNAL OF COMPARATIVE LAW], no. 2, 2006, at 1.
[57] Lihong Zhang, *The Latest Developments in the Codification of Chinese Civil Law*, 83 TULANE L. REV., 999, 1015 (2009).
[58] Wang, *supra* note 17, at 25-29.

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"the new humanism" as opposed to the property centered German tradition.[59]

(2) The degree of codification. The global trend of de-codification in recent years has been noticed and discussed among Chinese scholars. In an extreme end, some scholars believed that by taking the de-codification trend in Europe into consideration China would not need a comprehensive civil code and the process should be abandoned.[60] With a more modest approach Jiang and some other drafters held that the civil code to be adopted does not have to be "big and complete" and a "loosely structured code" would serve China the best.[61] In April 2005 an international conference on codification and de-codification was held in Shanghai where Professor Natalino Irti, a leading advocator for de-codification, with an open letter cautioned Chinese colleagues to adopt a civil code with a limited scope in line with the recent developments of civil law legislation in the world. According to him, the practice in China to develop detailed rules in subordinate special laws under some general abstract principles might represent a legislative trend in the civil law jurisdictions.[62] Some Chinese scholars also argue that it is still premature now to adopt a very comprehensive code with strict logic of the German style and such formulation may even seriously hinder the development of civil law in China. Thus, a moderate degree of civil law codification would be more appropriate.[63] But some scholars apparently want to pursue different approaches. For example, Wang argues that civil legislative system must be code-centered, which will not only ensure the unity of the system, but also exclude other sources. As such, civil law codification must first surmount the development of many self-developed

[59] Guodong Xu, *The Basic Structure of the Draft Civil Code*, FAXUE YANJIU [CASS J. OF L.], no.1, 2000, at 37–55; *see also* *see also* GUODONG XU, MINFA DE RENWEN JINGSHEN (HUMANISM SPIRITS OF CIVIL LAW) (2008).
[60] Xue Lu Xu & Peng Liang, *On Decodification*, SHIDAI FAXUE [PRESENT DAY LEGAL SCIENCE], no.4, 2005, at 71.
[61] Jiang, *supra* note 56.
[62] Natalino Irti, *De-codification in Europe and the Future of Civil Code of China: To Our Chinese Colleagues.*, *in* INTERNATIONAL CONFERENCE PAPER COLLECTION ON CODIFICATION AND DE-CODIFICATION, Vol. 2, 43 (2005); *see also* Zhang, *supra* note 57, at 1017.
[63] Lihong Zhang, *The Phenomenon of Civil De-codification and Formulation of Chinese Civil Law Code*, FAXUE [LEGAL SCIENCE], 2006, at 48-60; *see also* Xianchu Zhang, *Civil De-codification and Sensible Choice of China's Civil Legislation: Modest Degree Codification*, TANSUO YU ZHENGMING [EXPLORATION AND CONTENTION], no. 5, 2011, at 85–89.

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"micro-systems" within the current framework and avoid chaos caused by de-codification.[64]

(3) Based on the positions and approaches taken by different schools different structures and contents of the Civil Code have been put forward, which has become a major source of controversy. For instance, Liang has proposed his seven parts structure, including General Principles, Real Rights, General Provision on Obligations, Contract, Torts, Family Law, and Succession;[65] whereas Wang has insisted on the addition of a separate part on personality rights.[66] Some other experts have also developed a code draft with only four major component parts, including General Provisions, Personal Relationships, Property relations, and Supplementary Provisions.[67]

Rights of Intellectual property (hereinafter IP) are another battle field, since the 2002 Draft Code did not include IP rights, some scholars advocated for their inclusion in order to ensure a thorough and complete legal system of property rights for equal protection, although the legal sources, right contents and liability basis of IP law may be quite different from the traditional civil law.[68] However, Professor Wu Handong of Zhongnan University of Economics and Law disagreed. He questioned whether the paradigm for such inclusion had been established in civil enactments in major European countries. According to him, the Civil Code may just set out a couple of general provisions, leaving IP law relatively independent from civil law legislations for the sake of its own jurisprudence.[69]

A newly emerged controversy is on objects of civil rights. Although thus far, a consensus seems reached to include some provisions in this regard in the codification as a necessary measure to correct the ignorance of the Soviet ideology to the civil rights and the overconcentration of the BGB on properties rights. However, with respect to how to define and stipulate

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[64] Liming Wang, *The Code Centered Approach and Systemizing Civil Legislation in China*, YUNNAN DAXUE XUEBAO [JOURNAL OF YUNNAN UNIVERSITY - LAW EDITION], no. 2, 2009, at 2–9.
[65] THE LEGISLATIVE RESEARCH GROUP OF THE CHINESE ACADEMY OF SOCIAL SCIENCES, *supra* note 26.
[66] Wang, *supra* note 17, at 25-29.
[67] Guodong Xu, *The Basic Structure of the Future Chinese Civil Code*, FAXUE YANJIU (CHINESE JOURNAL OF LAW), no. 2, 2000, at 45.
[68] Qiying Wang, *Thoughts on Inclusion of Intellectual Property Rights into the Civil Code*, ZHISHI CHANQUAN [INTELLECTUAL PROPERTY], no. 2, 2000, at 45.
[69] Handong Wu, *Inclusion of IP Law into the Civil Code and General Provisions on Property Rights*, FAZHI YU SHEHUI FAZHAN [LAW AND SOCIAL DEVELOPMENT], 2015, at 58-67.

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these provisions, Professor Sun Xianzhong of the Social Academy of China insists to set them in the General Principles as a special chapter, as a deviation from the focus of the BGB General Principles merely *in rem,* to cover, inter alia, environment, animal, innovation protections.[70] However, Professor Yin is of the opinion that these rights should not be provided in the General Principles, but just subordinate chapters concerned to avoid confusion simply because the nature of these rights and their protection means are varied and different. He took enterprise rights as an example to question whether they should be provided as object of rights or subject of rights.[71]

(4) Civil codification and commercial legislation. As reflected above, by following the European tradition since the 1920s commercial law has been treated as a special part of civil law in China. After the formation of the PRC in 1949 the practice of the planned economy and rigid political ideology for three decades did not allow any room for market development as well as commercial law making. Once the GPCL was adopted as the first batch of comprehensive private law enactments in 1986, the model of combining civil and commercial rule enactment came back and has since been followed.

However, rapid development of a market economy in China has never stopped its demands for a separate set of commercial law rules.[72] Some scholars argue for the merits of such separation simply because commercial acts have their own characteristics, such as status of merchants, their business operation for profit and special concerns for formalities and safety of transactions. Moreover, unlike civil law, commercial law is an area subject to more public law intervention and regulation. Thus, as far as the civil and commercial law relation is concerned, commercial law should be applied first in practice due to its specialty.[73] On this basis some experts take Uniform

[70] FAZHI RIBAO [LEGAL DAILY], *supra* note 52.
[71] Tian Yin, *On the Structure of the General Principles of Chinese Civil Code*, BIJIAOFA YANJIU [JOURNAL OF COMPARATIVE LAW], no. 3, 2007, at 44-54.
[72] Kaixiang Liu, "On Nature, Basis and Characters of Commercial Law", *Zhongping Wang* [*China Review Net*], (March 2009), at http://www.china-review.com/sao.asp?id=21255; *see also* Xue Lu Xu, *On Integration of Commercial Law,* GUOJIA JIANCHAGUAN XUEYUAN XUEBAO [J. OF NATIONAL PROCURATORATE COLLEGE], no. 4, 2004, at 77-82; *see also* SHAOXIA SHI, SHANGFA SIKAO DE YINJI [MARKING OF COMMERCIAL LAW CONSIDERATIONS] (2008).
[73] BAOSHU WANG, SHANGFA ZONGLUN [GENERAL PRINCIPLES OF COMMERCIAL LAW] 27,28 (2007).

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Commercial Code of the United States (UCC) as an example to support their position.[74]

In recent years an alternative way has been advocated by some scholars led by Jiang and the late Professor Wang Baohu of Tsinghua University.[75] As a practical approach to deal with the dominant civil law tradition, the new strategy no longer insists on a separate commercial code, but a separate set of general principles within the current legal framework to govern commercial conducts and transactions, commercial subjects and their rights and to coordinate the existing commercial legislations. In this way, the controversy of civil-commercial law combination or separation could be avoided to a large extent.[76]

On this basis, some versions of general principles of commercial law have been worked out.[77] The most noticeable one among them is the Draft General Principles of Commercial Law developed by the Commercial Law Society of China in 2004–2009 with ten chapters on general principles, merchants, commercial conducts, commercial registration, commercial establishment, business transfer, commercial accounts, management and employee, agency and miscellaneous provisions.[78] However, the civil law school has openly disagreed with this approach. Professor Yang Lixin of the People's University, for example, states that under a civil code it is

[74] Xinrong Guan, *Exploring the New Open Path towards Enactment of General Principles of Commercial Law*, FAXUE [LEGAL SCIENCE], no. 8, 2010, at 27-28.
[75] Ping Jiang, *Some Macro-considerations on Civil Codification*, FAXUE [LEGAL SCIENCE], no. 2, 2002, at 41-42; *see also* Baoshu Wang, *Commercial Law Principles: Beyond Civil-Commercial Combination and Civil-Commercial Separation*, FAXUE YANJU [CASS J. OF L.], no. 1, 2005, at 32.
[76] As a matter of fact, with Wang as the leading drafter Shenzhen as a Special Economic Zone and a trial field of reform measures in China, promulgated its Commercial Ordinance in 1999 and further amended in 2004 with 65 articles in eight chapters. However, it was repealed in Dec. 2014 due to its limited use after the national legal framework has been established. An English translation of this Ordinance can be available at http://www.lawinfochina.com/display.aspx?lib=law&id=1658.
[77] YAN BO MIAO, SHANGFA TONGZE LIFA YANJIU [LEGISLATIVE STUDY ON GENERAL COMMERCIAL PRINCIPLES] 249-260 (2008); *see also* TAO FAN ET AL., SHANGSHI ZEREN YU ZHUISU JIZHI YANJIU [ON COMMERCIAL RESPONSIBILITY AND PROSECUTION MECHANISM] 177-188 (2008).
[78] A report of the drafting process is available at http://www.bhtlaw.cn/Introduction/Discussion/2009-12-16/287.html (in Chinese); and XR Guan, *New Path to Decoding the Puzzle of General Commercial Principles*, FAXUE [LEGAL SCIENCE], no. 8, 2010, at 23-30.

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unnecessary to adopt either a separate commercial code or general principles of commercial law.[79]

Although the Commercial law school suffered a heavy loss after Professor Wang passed away in 2015, more scholars stood up to express their support for the separation arrangement in the new round of civil law codification with even stronger tones. Professor Wang Yong of China University of Political Science and Law argued for "making a civil code with commercial law characters".[80] Professor Shi Tiantao of Tsinghua University even stated that it would be "ignorant and presumptuous" to attempt to include all civil and commercial laws into a uniform code.[81]

(5) Redefining the boundary of public and private law. Unlike capitalist countries, China today is still a socialist country practicing a "socialist market economy" with public ownership and state economy being guaranteed as the foundation of the economic system and the leading force of the country.[82] As such despite the dynamic marketization the notion made by Vladimir Lenin, the paramount leader of the former Soviet Union while adopting its Civil Code of 1922, that everything in economic areas should belong to governance of public law rather than private law[83] still sees its influences on civil and commercial legislation in China today. For instance, although equal protection has been stipulated as a basic principle of the Law on Rights *in rem*,[84] the existing enactments apparently provide the government with strong power to demolish houses and relocate the inhabitants with compulsory measures since unclearly defined "public interest" and government power have enjoyed superiority over private rights almost all the time. The right of private parties to challenge the government

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[79] *The Debates between Civil and Commercial Law Circles on Adoption of General Principles of Commercial Law Comes Back*, SHIJI JINGJI BAODAO [21ST CENTURY BUSINESS HEALD] (Guangdong, Jan. 13, 2009) http://finance.sina.com.cn/roll/20090113/02585751273.shtml.

[80] Yong Wang, *China Needs a Civil Code with Commercial Characters*, ZHONGGUO FALV PINGLUN [CHINA L. REV.], no. 4, 2015, at 30.

[81] Tiantao Shi, *Can Civil Codification Achieve Civil-Commercial Law Unification?*, ZHONGGUO FALV PINGLUN [CHINA L. REV.] no. 4, 2015, at 33.

[82] *See* Art. 7 of the Constitutional Amendments of 1993 and Art. 6 and 7 of the Constitutional amendeds in 2004.

[83] Quoted from Yimei Wu, *Exploring the Different Legislative Paths of Civil Codification in China and Russia*, QIUSHI [SEEKING TRUTH], no. 2, 2010, at 66; *see also* Epstein, *supra* note 15, at 162.

[84] *See* Law on Rights *in rem* (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), pt. I, ch. 1, art. 3-4, 2007 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).

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demolition decisions in the People's Court was not allowed until early 2011 under the pressure of a large number of fatal incidents in brutal demolitions nationwide.[85] Even under the new Regulation the rights and interest of lessee/tenants of the land to be taken is virtually ignored and the judicial remedy may be allowed only against the government decision concerning demolition and monetary compensation for the premises concerned, but not available for any equity claims for the land use right. According to a recent survey based on the government statistics, in 2010-2014 approximately 800,000 cases were filed against the government with more than 46% of which where land property related, and with only a 10% success rate.[86]

Apparently the codification may not progress well unless the boundary of public and private laws can be better defined. In current legislations, to a large extent the political ideology and public policy are still intermingled with private laws. For instance, the Law on State-Owned Assets of Enterprises sets out a legal duty to make the value of state investment "maintained and increasing" and to obtain the government approval of major company decisions before the shareholders' meeting.[87] Other similar examples may include legal mandates for not only establishment of grass-root organizations of the Communist Party in companies, but also provision of "necessary conditions" for their activities;[88] different standards to vitiate contracts against private and public interests in favor of state protection;[89] and prohibition of state owned enterprises from becoming a general partner of a partner firm.[90] In the most recent SOE reform, the Party-State demanded

[85] The State Council promulgated the Regulation on the Expropriation of Buildings on State-owned Land and Compensation on Jan 21, 2011 to replace the previous regulation adopted in 2001.
[86] Report, 800000 Lawsuits against the Government in Five Years with Only 10% Winning Rate, *Wangyi* [*Net Ease*] (Jan. 21, 2016).
[87] *See* Law on State-Owned Assets of Enterprises (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 28, 2008, effective May 1, 2009), ch. 1, art. 8 and ch. 5.1, art. 34, 2008 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).
[88] *See* Company Law (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 28, 2013, effective Mar. 1, 2014) (originally adopted as Company Law of the PRC (1993)), ch. 1, art. 19, 2013 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).
[89] *See* Contract Law (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999), ch. 3, arts. 52, 54, 1999 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).
[90] *See* Partnership Enterprise Law (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun. 1, 2007) (amending Partnership Enterprise Law (1997)), ch. 1, art. 3, 2006 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).

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to clarify the legal status of the Party leadership in companies and incorporate it into corporate governance in Chinese enterprises system.[91]

In more recent years a new debate has emerged on the legislative goal of civil and commercial laws. Some scholars, following the political policy of the CCP argue that "(development) efficiency first with attention to social justice" should still be the guiding principle in China's civil legislation;[92] whereas some others believe that in the legal field, the right goal should be social justice first with adequate attention to efficiency of the economic development.[93] In this regard, apparently the private law will lose its entire value if it becomes subordinate to the government policy, regardless of its political attraction and pride.

Despite the heated debates and innovative suggestions, the Draft Principles of the Civil Code submitted to the national legislature in June 2016 have apparently achieved limited doctrinal success. In terms of structure they have still followed the GPCL and maintained the chapters on contract, properties, torts, family relations and succession. Although some notable changes have occurred, such as to include the stipulation of entitlements of unborn fetus, reduction of limited civil capacity age from ten to six, recognition of virtual property, introduction of ecological restoration as a new civil liability and extension of statutory limitation from two to three years, were made, the Draft Principles are far from being adoptable. For instance, the failure to stipulate the principle of "absence of legal prohibition meaning freedom" in civil activities, omission of the personal information rights and unclear distinction of business and non-profitable juridical persons are pointed by the scholars as apparent defects.[94]

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[91] *See* The CCP and the State Council, The Guiding Opinions on Deepening the SOE Reform, para. 24 (Aug. 24, 2015).
[92] The view was endorsed by the Central Committee of the Communist Party of China in 1994 in its Decision on Certain Issues to Establish a Socialist Market Economy in China. For a recent article that continues to support the goal: *see* Li Li, *Conflicts and Choices of Value Goals in China's Civil Legislation*, FAXUE LUNTAN [LEGAL FORUM], no. 3, 2010, at 82.
[93] *See* QIU BEN, *Scientific Development and Legal System Construction*, IOLAW.ORG.CN (2005), http://www.iolaw.org.cn/showArticle.asp?id=1395.
[94] Report, "Consultation of the Draft Principles of Civil Law", Canxin Net, 6 July 2016, at. http://china.caixin.com/2016-07-06/100962883.html (in Chinese).

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5. FURTHER IMPLICATIONS OF THE CIVIL LAW CODIFICATION

The new round of codification, although is an encouraging move on the right direction, will also be a serious test to the Party-State's commitment to private right protection and development of the rule of law and civil society, or more specifically, as the first step to eliminate the ideology of the Leninism against private rights for a long time. Even after reform of almost forty years, "private" in many circles is still a dirty word. For instance, in all the official documents "non-public economy" has been used in order to avoid the term of private economy. The top leaders have routinely made their declaration firmly against privatization.[95] This in fact is just a reflection of the continued influence of the Soviet ideology where the term "private property" could not be used in the Soviet Constitution.[96]

In this context, given that freedom and civil society are the very foundations of civil law the codification itself will inevitably be a process to liberalize the people and the market from government control. In other words, to what extent the spirits of civil society embodied in civil law, such as individuals' freedom and autonomy, equal entitlement and protection, and empowering citizens to fight against the government intrusion, can be recognized in the codification will pose sensitive political challenges first to the Party-State and the test to measure the success of the codification.[97] This is echoed in the thesis of Professor Lawrence Friedman of Stanford University that codification may have great political meaning in a society.[98] Professor Yeong-Chin Su, a leading legal authority and Vice President of Judicial Yuan of Taiwan, also pointed out that civil legislation in mainland China has to compromise with the political ideology and as a result, whether

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[95] *See China Says Western-style democracy impossible for CCP Dinasty,* CHINA DAILY MAIL (Beijing, Mar. 13, 2013) https://chinadailymail.com/2013/03/13/china-says-western-style-democracy impossible-for-ccp-dynasty/.

[96] *See* Epstein, *supra* note 15, at 168.

[97] *See* Xianchu Zhang, *Level Playing Field as an Institutional Challenge to China as a Socialist Market Economy, in* FINANCE, RULE OF LAW AND DEVELOPMENT IN ASIA 76 (Jiaxing Hu, Matthias Vanhullebush, Andrew Harding eds., 2016).

[98] *Cf.* LAWRENCE M. FRIEDMAN, THE LEGAL SYSTEM 271 (1975).

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the legislation will lead to more institutional reform or enhanced instrumentalism need to be observed with uncertainty for a longer time.[99]

Despite heated debate on the direction, structure and content of civil law codification, it has been generally agreed that research and study on the fundamental theories and rules of civil/commercial laws and local conditions of transplantation of foreign institutions are still far from sufficient and thorough.[100] Particularly, some scholars argue that civil codification in China needs to breakthe yoke of not only political ideology, but also technical logic and structural patterns, otherwise the rules borrowed from the western world may not be effectively used to deal with the problems facing China as a transitional economy, such as equal competition, business autonomy and private property right protection. They have further criticized the codification movement to pursue more in form than the real spirit of civil law.[101]

Indeed, although currently all of the major components of civil law codification, including the Contract Law, the Law of Rights *in rem*, the Tort Liability Law and the Governing Law Applicable to Foreign Related Civil Relations, have been promulgated given the intense academic controversies reflected above the enactment progress is still facing a great deal of uncertainties. Moreover, the approach taken in the past 30 years to give way to comprehensive codification with a piecemeal enactment in order to deal with dynamic and rapid market developments in China has in turn significantly increased the difficulty to sort out the conflicts and inconsistencies in the existing legislation and digest them in a rational structure.

Although there have been serious debate on civil law codification and diversified transplantation of legal rules, fundamentally speaking, China has

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[99] *Compare* Yeong-Chin Su, *System Orientation and Construction Rules of Modern Civil Code—Suggestions to Civil Codification of Mainland China*, JIAODA FAXUE [L. J. OF JIAOTONG U.], no. 1, 2010, at 92.

[100] *See* Zuo Zuo Shen & Xiao Geng Zhao, *Ten Academic Years of Civil Codification: 1997-2007*, HENAN ZHENGFA GANBU GUANLI XUEYUAN XUEBAO [JOURNAL OF HENAN ADMINISTRATIVE INSTITUTE OF POLITICS AND LAW], no. 4, 2011, at 116; and Jiang Yu, *Centenary Notes on Civil Codification in China Since 1911,* ZHENGFA LUNTAN [TRIBUNE OF POL. SCIENCE AND L.], no. 4, 2011, at 116.

[101] *See* Yiyong Su, *Form at the Expenses of True Significance: From the Tang Lu Complex to Civil Code Complex,* ZHONGGUO SHEHUI KEXUE [SOC. SCIENCES IN CHINA], Summer 2005, at 123.

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maintained its civil law tradition. As Professor Christiane C. Wendehorst of Vienna University observed, "I have never seen any scholars who support the *Pandekten* system as strong as I saw in China. Many of them favor the German law even more than myself."[102] Codification in China has long been viewed as a crucial benchmark of maturity of a legal system, the highest stage of legal systematization and the full display of institutional civilization.[103] As such, despite uncertainties and difficulties civil law codification will continue to be the goal of the national legislature.

As reflected above, the relationship between civil and commercial legislation must be further sorted out in the course of civil law codification. In fact, the approach to combine civil and commercial legislation has led to some irrational results in dealing with civil and commercial disputes. For instance, Art. 121 of Contract Law of 1999 has introduced strict liability to deal with any breach regardless of civil or commercial contracts. This is considered an example of "over-commercialized legislation".[104] By the same token, Art. 410 of the Contract Law provides that both the principal and the agent may terminate a mandate contract any time without differentiating the nature of contracts concerned, which is identified an example of "under-commercialized legislation".[105]

Despite the enthusiasm on the German *Pandekten* system, the legislation with the piecemeal, pragmatic and extensive transplanting approach since the 1970s have also made the legal system suffer from lack of internal coordinated synergy. Rationalization and harmonization of the entire system are further complicated with the transplantation of many private law rules from not only civil, but also common law jurisdictions extensively for many years, such as floating charge,[106] business

[102] Christiane Wendehorst, *Exploring Uniformed Civil Code: A Comparative Study of EU and China*, QUINGHUA FAXUE [TSINGHUA L. J.], no. 4, 2010, at 13.
[103] *See* Liming Wong, *Formulation of Civil Code in China: Review and Prospective,* FAXUE LUNTAN [LEGAL FORUM], no. 5, 2008, at 5); and Tian Yin, *On Civil Law Codification in China*, ZHENGZHI YU FALV [POL. SCIENCE AND L.] , no. 2, 2006, at 60-66.
[104] Gu Zhang, *Commercial Law as a Hermit Crab – on Independece and Special Characteristics of Commercial Law,* QINGHUA FAZHI LUNHENG [TSINGHUA J. OF RULE OF L.], 2005, at 25.
[105] Yan Chuan Wang, *Types of Commercial Conducts and DIversified Legislation,* DANGDAI FAXUE [CONTEMPORARY L. REV.], no. 4, 2011, at 67, 74.
[106] *See* Law on Rights *in rem* (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), pt. IV, ch. 17.2, art. 223, 2007 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).

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reorganization with debtor in possession,[107] derivative action,[108] independent directors,[109] punitive damages,[110] limited liability partnership[111] and a trust system.[112] It seems the trend now that although the civil law tradition may still dominate legislation on civil matters, commercial enactments are increasingly subject to heavy influence of common law rules and doctrines.

Heated academic debate will no doubt deepen understanding of the key issues concerned and facilitate progress of the civil law codification, however, the irrational division of teaching and research work leading to a variety of schools and study associations with sectarian bias has complicated the situation. Thus far the national Civil Law Association and Commercial Law Association as well as Economic Law Association have been established separately with their annual conferences and research agendas. In the debate over how to define the borderline of different subjects, some scholars have even denied the necessity to have any separate department of commercial law. According to them, combination of civil and commercial laws and expansion of public law into private areas have left no basis for independence of commercial law.[113] Such quarrel seems to aim more at increasing influence of certain schools than at promoting academic comprehension.

Civil and commercial law enactments in China offer some interesting experiences not only to diversification of law, but also comparative law theories on legal transplantation or transformation. According to Professor Pitman Potter of University of British Columbia, China has taken a dynamic

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[107] *See* Enterprise Bankruptcy Law (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun. 1, 2007), ch. 8.1, art. 73, 2006 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).
(*See* Art. 73 of the Enterprise Bankruptcy Law of 2006.)

[108] *See* Company Law (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 28, 2013, effective Mar. 1, 2014) (originally adopted as Company Law of the PRC (1993)), ch. 6, art. 151, 2013 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).

[109] *Id.* ch. 4.5, art. 122.

[110] *See* Tort Liability Law (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 26, 2009, effective Jul. 1, 2010), Ch.5, art. 47, 2009 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).

[111] *See* Partnership Enterprise Law (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun. 1, 2007) (amending Partnership Enterprise Law (1997)), ch. 2.6, 2006 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).

[112] *See* Trust Law (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 29, 2001, effective Oct. 1, 2001), 2001 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).

[113] *See* Jichun Shi & Yueqin Chen, *On Commercial Law*, ZHONGGUO FAXUE [CHINESE LEGAL SCIENCE], no. 4, 2001, at 91-104 (2001); *see also* Jichun Shi & Haifang Yao, *On Commercial Law Again*, BEIJING SHIFAN DAXUE XUEBAO [J. OF BEIJING NORMAL U. - SOC. SCIENCE EDITION], no.1,2003, at 45-48.

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strategy of selective adaptation to balance local needs with external conditions.[114] Although the important role of civil and commercial legislations in promoting China's opening and modernization should be fully recognized, certain side-effects should also be noted. However, a jigsaw puzzle situation of the Chinese private laws with the combination of the Party-State ideology, international borrowing from both civil and common law jurisdictions, the transitional needs and local characteristics have thus far rendered the system confusing, inconsistent, and poorly functioned. It has been openly admitted that "The vitality of laws lies in their enforcement" is a challenge facing China's rule of law development.[115] From this perspective, the new round of codification should be best used as an opportunity to not only systemize, but more importantly rationalize and harmonize the current legislations.

In addition to the compilation of legal rules, the new round of civil codification will inevitably have implications on reorientation of legal culture in China. As some experts pointed out, unlike Roman private law with a formally rational system of applying law to factual problems,[116] the German pandectists are more difficult to borrow since a part of general principles for the whole system is added. As a result, transplantation may have to be made on a wholesale basis.[117] However, this approach has not worked coherently with other cultural force in China, such as the Confucianism with emphasis on social norms and the former Soviet Union ideology subordinating private rights to the Party-State interest. For example, some scholars have argued for shifting the paradigm from Western analyzing approach to Eastern synthesizing approach with due attention to not only the system of civil law, but also internal logic relations of the rules and the inner structure as well as relations of different values.[118]

The legislative and academic debates have also reflected in the judicial practice. The first independent unit within the People's Court responsible for

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[114] *See* Pitman B. Potter, *Globalization and Economic Regulation in China: Selective Adaptation of Globalized Norms and Practices,* 2 WASH. U. GLOBAL STUD. L. REV. 119 (2013).
[115] Info. Office of the State Council, China, *The Socialist System of Laws with Chinese Characteristics* (Oct., 2011), http://www.scio.gov.cn/zfbps/ndhf/2011/Document/1036756/1036756.htm.
[116] *See* Weber, *supra* note 15.
[117] *See* Epstein, *supra* note 15.
[118] *See* Han, *supra* note 23, at 210.

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handling cases of commercial nature was named "economic trial division" and first established at the local level in 1979, parallel with the division of civil trials. Such practice was soon expanded to the entire judicial system, including the Supreme People's Court. Under the Preliminary Opinion of the Supreme People's Court on the Scope of Jurisdiction of Economic Trial Division of 1980, the newly established division was empowered to hear disputes concerning contract, finance, insurance and intellectual property rights between enterprises. In 1980s jurisdiction of the economic trial division was further expanded to hear disputes on trade, transportation, bankruptcy, commercial paper, financial lease, competition, securities and tort liabilities concerning enterprises.[119] Such development clearly reflected a practice to separate economic/commercial case handling from traditional civil trials.

The direction, however, was changed in 2000 when the entire people's court system was restructured as part of preparation work for China's accession to the WTO. With the approval of the CCP, a larger civil trial division was established with commercial trial as one of the subdivision. The new civil trial division includes four sub-divisions with roughly divided jurisdiction to deal with traditional civil cases, commercial cases, intellectual property right cases and foreign related cases respectively.[120] However, the division of the jurisdiction seemed to be based on an irrational foundation. For instance, the first trial division is empowered to hear not only family and tort cases, but also labor, real property development and security, and construction disputes. As a result, although the reform in a sense further promoted private rights protection with more judicial attention and resource and streamlined the functions of judicial branches, inclusion of the commercial trials into the larger civil law system has been pretty controversial since the philosophical age and valued to settle commercial cases, such as market efficiency, safety of transaction, and business autonomy, may be different from those of civil cases handling and such blending may hinder development of commercial trials according to its own

[119] *See* Supreme People's Court, National Conference of Economic Trials (May 6, 1993) (transcript available in China Investment Website).
[120] *See The SPC Implements at the Full Scale Institutional Reform,* RENMIN RIBAO HAIWAI BAN [PEOPLE'S DAILY-OVERSEAS EDITION], (Beijing, Aug. 9, 2000).

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norms and logics. Such difference is well illustrated in a recent case study survey conducted by two Beijing judges. While facing a dispute concerning the enforcement of a liquidated damage provision of a contract, most of the thirty civil judges involved in the study opined that excessive freedom of contract has led to an unfair result, whereas almost all of the thirty commercial judges held that the parties' autonomy and bargain should be respected.[121]

Furthermore, as indicated above, in the past forty years a very large number of judicial circulars and interpretations have been promulgated to guide the judicial practice with the legal weight as the law.[122] Most of these rules have been adopted according to the practical needs with a pragmatic approach with the judicial activism, such as an insurance company being held to have effectively waived its rights to deny the validity of an insurance contract where it was entered with the company's knowledge that the insured failed to carry out her duty of full disclosure.[123] Sometimes these judicial rules may not be even read together with the enactments concerned. For example, Art. 51 of the Contract Law provides that a contract concluded by a party without disposition right shall be invalid (e.g. the contract not formed), unless the transaction is ratified by the right owner, or the contracting party obtained the right after the conclusion of the contract concerned; but Art. 3 of the SPC Interpretation on Dealing with Sales Contract Disputes dated 10 May 2012 stipulates that the People's Court shall not support the claim to invalidate a contract made by a buyer on the ground that the seller does not have the ownership or disposition right over the subject matter at the time of contracting, although he may be entitled to damages and rescission (e.g. the contract formed already).[124]

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[121] *See* Chun Peng & Guorong Sun, *Considerations and Practice of Commercial Trials under the Larger Civil Division Framework*, FAÒV SHIYONG [J. OF THE NAT'L JUDGES COLLEGE OF THE SPC], no. 12, 2012, at 68-69 .

[122] *See* Law on Legislation (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 15, 2015, effective Mar. 15, 2015) (amending Law on Legislation (2000)), ch. 6, art. 104, 2015 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (China).

[123] *See* He Lihong v. Shunde Sub-branch and Foshan Branch of China Life Insurance Co., decided by the Intermediate People's Court of Foshan on 10 Jan. 2006; *see also* endorsed by the SPC, in *Zuigao Renmin Fayuan Gongbao* [*The SPC Gazette*], vol. 2008, at 142 (in Chinese).

[124] *See* Interpretation of the Supreme People's Court on Issues Concerning the Application of Law for the Trial of Cases of Disputes over Sales Contracts, Supreme People's Court (2012), http://lawinfochina.com/display.aspx?lib=law&id=10976&EncodingName=gb2312.

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Apparently, as compared with the courts in Germany where precedents may just play a limited role for persuasion and treated as a "source of soft law",[125] the Supreme People's Court has been playing a much more active role in law-making. However, thus far not much attention has been paid to sorting out and incorporating the judicial contributions to civil/commercial law developments in the civil codification as a crucial part of the legislation. As a result, its legal status, relationship with the civil code and necessary consolidation to a large extent are still left untouched. Professor Xue Jun of Peking University has warned that the civil law codification has strayed from the right path to rationalize the legal rules, sources and structures. Without necessary correction, the codification will have no substantial sense, but add more disarray in the legal practice.[126]

Last, but not least, increasing influence of legal experts and scholars in civil and commercial law codification should be recognized as an important contribution to the rule of law development in China. For a long time, legislative process has been dominated by government departments and officials, where rules are often adopted not for promoting social justice, but safeguarding bureaucrats' interest and power. Such practice has become a source of social conflicts.[127] In civil law codification and enactment of other basic civil and commercial laws, the academic complexity and professional technicality have to a large extent prevented bureaucrats from overstepping into the legislative process. As reflected above, it has become a practice that the top national legislature would entrust the drafting of these laws to a jurist group to set out the legislative basis. This has been praised as not only a better way to improve legislative quality, but also an important means to develop democratic enactment.[128]

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[125] Vincy Fon & Francesco Parisi, *Judicial Precedents in Civil Law Systems: A Dynamic Analysis,* 26 INTL. REV. OF L. AND ECON. 519 (2006).
[126] *See* Jun Xue, *How Judicial Interpretation Be Treated in Civil Law Codification?,* ZHONGGUO FAÒV PINGLUN [CHINA L. REV.], no. 4, 2015, at 48.
[127] *See* LI YIA BIAO , *Interest Expansion Behind Bureaucratic Legislation: Respecting People's Will or Bureaucrat's Interest?*, NEWS.XINHUANET.COM (Mar. 12, 2006), http://news.xinhuanet.com/misc/2006-03/12/content_4294131.htm. *See also* Qiu, F, Towards Democratic Legislation, Zhongguo Xinwen Zhoukan [*China News Weekly*] (Mar. 7, 2005), http://finance.qq.com/a/20050307/000105.htm.
[128] *See* Jihong Mo, "Expert Participation in Law-Making: An Important Way of Democratic Legislation", Zhongguo Zhengxie Bao [*Journal of China Political Consultative Conference*], 9 Nov. 2009.

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6. CONCLUSION

Economic reform and opening the door for almost forty years have changed China greatly and prepared conditions for its development toward a civil society with basic civil and commercial laws having been promulgated on the basis of the GPCL. On this basis, the new round of civil law codification will certainly provide new momentum with China's market development and legal modernization. However, the codification is still facing great uncertainties from political, cultural, doctrinal aspects known as Chinese characteristics. As Professor Hein Kötz of Max-Planck-Institute pointed out, "In language, method, structure and concept the Draft (Civil) Code (of China) is a 'learned' code clearly based on what is sometimes called the civil law tradition."[129] However, amongst all the challenges, changing f the traditional political ideology and transferring powers from the Party-State to more respect private rights and the rule of law will be the most daunting one. In this regard the development path of China may be no exception to those of other market oriented jurisdictions.[130]

[129] *See* Hein Kötz, *Foreword to* THE LEGISLATIVE RESEARCH GROUP OF THE CHINESE ACADEMY OF SOCIAL SCIENCES, *supra* note 26, at XXVI.
[130] *See* Tom Ginsburg, *Does Law Matters for Economic Development? Evidence from East Asia,* 34 L. & SOC'Y R. 829; and Chenggang Xu, *China's Political Economic Institutions and Development,* 35 CATO. J. 525 (2015).

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The European Union's Emerging Approach to ISDS: a Review of the Canada-Europe CETA, Europe-Singapore FTA, and European-Vietnam FTA

GUS VAN HARTEN†

TABLE OF CONTENTS: 1. Introduction; 2. Response to the Lack of Judicial Independence in ISDS; 3. Response to the Lack of Procedural Fairness in ISDS; 4. Response to the Lack of Balance in ISDS; 4.1. Foreign Investor Rights, Without Responsibilities; 4.2. Expansive Scope of Foreign Investor Rights and Protections; 4.2.1. Broad Access to ISDS; 4.2.2. Expansive Version of Fair and Equitable Treatment; 4.2.3. Other Foreign Investor Rights; 4.3. Affirmation of the Right to Regulate; 5. Conclusion.

ABSTRACT: The European Union's approach to ISDS is examined based on the available textual evidence in proposed or negotiated trade agreements. The evaluation focuses on three criteria: judicial independence, procedural fairness, and balance in the allocation of rights and responsibilities. Each criteria arises from concerns about the powerful and far-reaching arbitration mechanism at the core of ISDS and its role to decide the legality of sovereign conduct and allocate public funds to foreign investors. The main conclusions are that, in pursuing a massive expansion of ISDS in new trade agreements, the European Union has taken only partial steps on the issue of independence, has signalled but not carried through with steps on the issue of procedural fairness, and has not taken steps to balance investor rights with investor responsibilities or to ensure respect for the role of domestic courts.

KEYWORDS: *Foreign Investment; International Arbitration; Trade Negotiations; European Union*.

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1. INTRODUCTION

Investor-state dispute settlement (hereinafter ISDS) is an exceptionally powerful form of international adjudication that regulates and disciplines the legislatures, governments, and courts of countries for the main purpose of protecting foreign investors. Treaties that allow for ISDS claims against countries do so based on broadly-framed rights, without actionable responsibilities, for foreign investors that are enforceable in non-judicial arbitration processes. These processes are subject to limited judicial review (in a jurisdiction usually chosen by the ISDS arbitrators) or to limited non-judicial review by three arbitrators selected for each case by the World Bank President or another default appointing authority. ISDS tribunals are especially powerful because their awards and other decisions are enforceable directly against assets of the losing country located in other countries; in this respect, they are more powerful than other adjudicative forums, including domestic and international courts, that involve the review of sovereigns.[1]

To date, ISDS has been used to order public compensation mostly for very large multinational companies and very wealthy individuals in a range of regulatory areas. Compensation has been ordered by ISDS tribunals both for general and for specific decisions taken by countries' legislatures, governments, or courts.[2] The exclusive access to ISDS that is given to foreign investors, especially companies and individuals more able to finance expensive ISDS litigation, gives such investors a unique ability to influence sovereign decision-making in their favour at the expense of those with conflicting interests and no corresponding access to ISDS.

ISDS was developed in the late 1960s and 1970s for the resolution of foreign investor disputes regarding relations between developed and either developing or transition countries or, alternatively, among developing or transition countries. In contrast, ISDS has been agreed rarely among developed countries, whose judicial systems have a stronger claim than ISDS

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[1] *See* GUS VAN HARTEN, INVESTMENT TREATY ARBITRATION AND PUBLIC LAW 117-119 (2007).
[2] *See* GUS VAN HARTEN, SOVEREIGN CHOICES AND SOVEREIGN CONSTRAINTS 52-54, 82-89 (2013).

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to attributes of public accountability, judicial independence, and procedural fairness. Since the expansion and exploding use of ISDS in the 1990s, only two contexts for ISDS have involved relations among developed countries. The first is between Canada and the United States under the North American Free Trade Agreement (hereinafter NAFTA).[3] The second, limited to the energy sector, is among Western European countries under the Energy Charter Treaty.[4] Like most of the treaties that allow for ISDS, both NAFTA and the Energy Charter were negotiated and concluded in the early or mid-1990s before the major wave of ISDS claims against countries started in the late 1990s. Yet NAFTA and the Energy Charter Treaty have generated more ISDS claims than thousands of other treaties allowing for ISDS; together, they account for about one quarter of all known ISDS claims.[5] Therefore, it is significant that governments, especially Washington and Brussels but also, for example, Ottawa and Beijing are presently pushing for a further major expansion of ISDS in the context of relations with and among developed countries. By expanding ISDS in this realm, governments will enlarge by several times the reach of ISDS tribunal power.[6]

In this paper, I examine the available textual evidence in order to assess the form of ISDS to which the European Union has given preference since entering the field of ISDS. This textual evidence comes from four proposed trade deals. The most significant is also the least evolved in negotiation: the Europe-U.S. Transatlantic Trade and Investment Partnership (hereinafter TTIP), for which a text for a TTIP investment chapter as proposed by the E.U. is publicly available.[7] For each of the other three

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[3] North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 296 and 605 (entered into force Jan. 1, 1994) [hereinafter NAFTA].

[4] Energy Charter Treaty (annex I of the Final Act of the European Energy Charter Conference) Dec. 17, 1994, 34 I.L.M. 373.

[5] Based on data compiled by the author, 125 (32%) of 395 known treaty-based foreign investor claims as of May 2015 were initiated under NAFTA or the Energy Charter Treaty. Of these 125, 71 were initiated under NAFTA and 54 under the Energy Charter Treaty, with 5 of the 54 initiated under both the Energy Charter and a bilateral investment treaty.

[6] *See infra* notes 93-94 and accompanying text.

[7] European Union, *Transatlantic Trade and Investment Partnership – Trade in Services, Investment and E-Commerce – Chapter II-Investment*, EU-proposed text of TTIP investment chapter, (Nov. 12, 2015), http://trade.ec.europa.eu/doclib/docs/2015/november/tradoc_153955.pdf [hereinafter TTIP investment chapter]. See also European Commission, *Public consultation on modalities for investment protection and ISDS in TTIP*, (Mar. 27, 2014), http://trade.ec.europa.eu/doclib/docs/2014/march/tradoc_152280.pdf; all page number references are to the online pdf version in which the pages are not numbered [hereinafter TTIP consultation text].

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agreements, a public text of the full agreement is available although the agreements have not been finalized and each agreements is at somewhat different stages in the process toward possible ratification. They are the Canada-Europe Comprehensive Economic and Trade Agreement (hereinafter CETA),[8] the Europe-Singapore Free Trade Agreement (hereinafter Singapore FTA),[9] and the Europe-Vietnam Free Trade Agreement (hereinafter Vietnam FTA).[10]

My evaluation of the E.U. "model" of ISDS, as represented by these proposed agreements, focuses on three criteria: judicial independence, procedural fairness, and balance in the allocation of rights and responsibilities. Each criterion arises from concerns that have been expressed about the use of ISDS — and, more precisely, the powerful and far-reaching arbitration mechanism at the core of ISDS — to decide the legality of sovereign conduct and to allocate public funds to foreign investors.[11] Two of the criteria, independence and fairness, reflect elements of a judicial process as characterized especially in contexts where judicial processes are used for the final resolution of disputes about sovereign conduct.[12] The third criteria, balance, is meant to convey a modest and formal idea of equanimity in the allocation of rights and responsibilities as well as the notion of respect in international adjudication for the role of other decision-making bodies, especially domestic courts.

The main conclusions of this assessment are that, in pursuing a major expansion of ISDS, the European Union has taken partial steps on the issue of independence, signalled but not carried out steps on the issue of procedural fairness, and taken significant steps to affirm the state's right to regulate but

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[8] Comprehensive Economic and Trade Agreement, Can.-EU, Feb. 29, 2016, http://trade.ec.europa.eu/doclib/docs/2016/february/tradoc_154329.pdf [hereinafter CETA].

[9] Free Trade Agreement, Sing.-EU, ch. 9, June 29, 2015, http://trade.ec.europa.eu/doclib/docs/2014/october/tradoc_152844.pdf [hereinafter Singapore FTA].

[10] Free Trade Agreement, Viet.-EU, ch. 1-7, Dec. 2, 2015, http://trade.ec.europa.eu/doclib/docs/2016/february/tradoc_154210.pdf [hereinafter Vietnam FTA].

[11] *See* Gus Van Harten, *Investment Treaty Arbitration, Procedural Fairness, and the Rule of Law*, *in* INTERNATIONAL INVESTMENT LAW AND COMPARATIVE PUBLIC LAW 23 (Stephan W. Schill ed., 2010); Van Harten, *supra* note 1, at 159-75.

[12] For an elaboration, see Gus Van Harten, *The EC and UNCTAD reform agendas: Do they ensure independence, openness, and fairness in investor-state arbitration?*, *in* SHIFTING PARADIGMS IN INTERNATIONAL INVESTMENT LAW: MORE BALANCED, LESS ISOLATED, INCREASINGLY DIVERSIFIED (Steffen Hindelang, Markus Krajewski eds., 2016).

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not to balance investor rights with investor responsibilities or to respect the role of domestic courts. On ISDS's lack of independence, in particular, the CETA, Vietnam FTA, and proposed TTIP investment chapter, but not the Singapore FTA, incorporate significant though incomplete improvements. On the issue of procedural fairness, the E.U.'s proposed TTIP investment chapter text incorporated steps to address the lack of procedural fairness in ISDS, but these steps were not included in any of the other three agreements, at least two of which were subject to negotiation after the TTIP investment chapter text was made public. On the issue of balance, none of the agreements address the lack of balance in the allocation of foreign investor rights and responsibilities in ISDS. Also, while the CETA has improved language on the so-called right to regulate (a euphemism in international investment law for the role of democracy, government, and judicial decision-making), all four of the agreements have codified an expansive version – compared to the U.S. approach – of the notoriously malleable foreign investor right to "fair and equitable treatment". Finally, on the issue of balance, none of the four agreements addresses ISDS' lack of respect for domestic institutions, especially domestic courts. Rather, by relieving foreign investors of any responsibility to demonstrate failings of domestic courts before bringing an ISDS claim, all of the agreements are premised on an implicit assumption that the courts in Europe and the other relevant countries fail systemically to offer justice for foreign investors. Overall, these agreements indicate that the European Union was originally prepared to accept a primarily U.S. approach to ISDS, albeit now with significant variations that emerged after the political debate about ISDS unfolded in Europe. The question remains whether such variations in the CETA, Singapore FTA, and Vietnam FTA will be maintained in the face of much stronger U.S. bargaining power in the TTIP negotiations.

2. RESPONSE TO THE LACK OF JUDICIAL INDEPENDENCE IN ISDS

To be judicially independent, ISDS would need to incorporate the conventional institutional safeguards that alleviate concerns about unacceptable judicial dependencies, especially financial and economic. That

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is, it would need to ensure that ISDS adjudicators had security of tenure and a set salary, that ISDS cases were assigned objectively to individual adjudicators such as by lottery or rotation, that outside lawyering by the adjudicators was prohibited, and that an independent judicial process was available to resolve conflict of interest claims against adjudicators. These are common features of domestic courts and other international tribunals that resolve disputes involving sovereign conduct. Historically, ISDS has not incorporated them, allowing instead for a for-profit adjudication based on an hourly or daily rate, ultimate control by executive officials over case assignments, allowance for outside legal work by ISDS arbitrators, and referral of conflict of interest claims first to other arbitrators and then to executive officials. The resulting lack of institutional independence in ISDS provides a basis for reasonable apprehension of bias that taints ISDS outcomes regardless of who they favour.[13]

In its proposals of November 2015 for an investment chapter in the TTIP, the European Union took a different approach to ISDS. This different approach was then incorporated, in large part, as part of the Vietnam FTA of December 2015 and the revised CETA of February 2016. In assessing how the E.U.'s reforms impact the issue of independence, I focus on these two agreements instead of the TTIP proposal because they are purportedly finalized texts and thus more reflective of what the European Union appears willing and able to achieve in actual negotiations with treaty partners.

Most significantly, in the revised CETA and Vietnam FTA, steps were taken to address the lack of independence in ISDS.[14] ISDS adjudicators under the CETA will be members of a roster with a reasonable degree of security of tenure. There will also be more public accountability in their initial appointment, albeit with a potentially driving role in appointment decisions given to trade officials rather than higher-level publicly-accountable decision-makers, and adjudicators will be assigned to cases through an objective process of rotation. Furthermore, adjudicators will not be permitted to work on the side as counsel in other ISDS cases although, remarkably, they are not prohibited from working on the side as ISDS arbitrators, thus

[13] *See* Van Harten, *supra* note 11.
[14] *See* CETA, *supra* note 8, art. 8.27; *see also* Vietnam FTA, *supra* note 10, art. 12 of ch. II, sec. 3.

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apparently permitting a party to an ISDS dispute to appoint a CETA ISDS roster member as an arbitrator in an ISDS dispute under another treaty and to pay him or her directly and lucratively in that other context.[15] This aspect of the revised CETA – along with its language on the required or preferred expertise of ISDS adjudicators and the potentially dominant role of trade officials in appointments to the roster[16] – suggests that a way may have been cleared for the same small group of individuals who have dominated ISDS decision-making so far, and leaned heavily toward expansive/ pro-claimant investor resolutions of contested legal issues under investment treaties[17] – to populate the CETA ISDS roster.

More fundamentally, on the criterion of independence, ISDS under CETA would still rely on an essentially for-profit model of ISDS adjudication because the adjudicators are to be paid a daily rate, making them financially interested in the frequency and duration of proceedings and thus dependent in general on deep-pocketed investors as the most likely prospective claimants to support growth of the ISDS industry. This aspect of ISDS has been ameliorated to an uncertain degree in CETA by its incorporation of a set retainer, of unknown value, for adjudicators alongside their daily rate of compensation. Even so, the remunerative set-up remains inappropriate, especially for determining such important matters as the legality of laws, regulations, policies introduced by countries and the allocation of potentially vast amounts of public money to private parties. Where only one side (foreign investors) can bring the claims that trigger the appointment and remuneration of ISDS adjudicators, the process still creates unacceptable dependencies among the adjudicators and falls short of a judicial standard.

In contrast, the Singapore FTA evidently has not been adjusted, as the CETA was, to incorporate any of the reforms related to judicial

[15] *See* CETA, *supra* note 8, art. 8.30(1); *see also* Vietnam FTA, *supra* note 10, art. 14(1) of ch. II, sec.3.

[16] *See* CETA, *supra* note 8, art. 8.27(4); *see also* Vietnam FTA, *supra* note 10, art. 12(4) of ch.II, sec. 3. In particular, each agreement limits the expertise or experience of ISDS arbitrators to the fields of public international law, international trade law, and, especially, international investment law.

[17] *See* Gus Van Harten, *Arbitrator Behaviour in Asymmetrical Adjudication: An Empirical Study of Investment Treaty Arbitration*, 50 OSGOODE HALL L. J. 211 (2012); *see also* Gus Van Harten, *Arbitrator Behaviour in Asymmetrical Adjudication (Part Two): An Examination of Hypotheses of Bias in Investment Treaty Arbitration*, 53 OSGOODE HALL L. J. 540 (2016).

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independence.[18] Rather, the Singapore FTA still contemplates the old ISDS process – without security of tenure, set salaries, objective case assignment, and prohibitions on outside ISDS counsel work – that create reasonable suspicions of bias. Depending on the circumstances, these suspicions may operate in favour of a country, a foreign investor, or another party. To illustrate, ISDS arbitrators who lack security of tenure and seek repeat appointments are financially dependent on whoever has the power to appoint the arbitrators (where the foreign investor and sued country do not agree or do not appoint). On this issue of default appointment authority, the Singapore FTA designates an executive official, the Secretary General of the World Bank's International Centre for Settlement of Investment Disputes (ICSID),[19] as the appointing body. Yet it is inconsistent with judicial independence to allow an executive official to choose who will decide an adjudicated case in circumstances where the executive official knows who has sued whom and in what context. Allocating appointing power in this way gives an opportunity for the executive official to keep sensitive cases in safe hands in accordance with the politics of the claim.

In the Singapore FTA, the most significant step on independence is the proposed incorporation of a code of conduct for ISDS arbitrators.[20] This is a weak step due to the form of the proposed code, which would not incorporate the institutional safeguards of independence mentioned earlier. Indeed, the code would apparently not even stop ISDS arbitrators from working on the side as ISDS lawyers, which is among the more obvious contributions that a code could make. Additionally, the code would be policed by an executive official based on case-by-case complaints filed by disputing parties about alleged conflict of interest of individual arbitrators.[21] This check is inadequate in various ways. For example, it assumes that the disputing parties would be able to uncover the outside counsel work of an ISDS arbitrator, even though the existence and tribunal make-up of ISDS

[18] I refer to the June 2015 version of the Singapore FTA, *supra* note 9. The Singapore FTA investment chapter may change significantly, as did the Canada-E.U. CETA, following legal scrubbing and renegotiation.
[19] *See* Singapore FTA, *supra* note 9, art. 9.21(2).
[20] *See* Singapore FTA, *supra* note 9, annex 9-B.
[21] *See* Singapore FTA, *supra* note 9, art. 9.21(10).

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arbitrations can be kept completely secret under some treaties.[22] Unless an ISDS arbitrator under the Singapore FTA declares a potential conflict, an affected disputing party would have no way of discovering the arbitrator's role as counsel.

Unlike the CETA and Vietnam FTA, the Singapore FTA does not move towards establishing a mandatory roster of ISDS adjudicators who would be assigned to cases objectively. Instead, in the Singapore FTA, the contemplated roster does little to address ISDS' lack of independence because (a) the roster would not apply to all arbitrators appointed to each ISDS tribunal, (b) an executive official would retain the power to choose who from the roster is assigned to individual cases, and (c) the executive official would be able to appoint individuals from outside the roster if the states parties to the treaty did not agree on the roster's membership.[23] For two decades, this last loophole has helped foil a similarly weak roster in NAFTA's ISDS system.[24]

Absent the safeguards of judicial independence, ISDS outcomes are tainted regardless of other aspects of the treaty text or the personal integrity of adjudicators. In essence, the Singapore FTA, and to a lesser extent the CETA and Vietnam FTA, allow foreign investors to choose to remove adjudicative power from domestic or European courts, by bringing an ISDS claim, and reallocate it to a small group of ISDS adjudicators and executive officials, none of whom are institutionally independent in the manner of a domestic or international judge. This lack of independence remains a critical issue in the CETA and Vietnam FTA and, more completely, in the Singapore FTA.

3. RESPONSE TO THE LACK OF PROCEDURAL FAIRNESS IN ISDS

ISDS is unfair for various reasons, including its lack of judicial independence. Another key source of unfairness in ISDS is procedural. A basic principle of

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[22] The problem of complete secrecy appears most acute in arbitration under the International Chamber of Commerce (ICC) arbitration rules. *See* Gus Van Harten, *A Total Lack of Transparecy,* CANADIAN LAW. (Oct. 24, 2011), http://www.canadianlawyermag.com/3912/A-total-lack-of-transparency.html.
[23] *See* Singapore FTA, *supra* note 9, art. 9.21 (2) and (4).
[24] *See* NAFTA, *supra* note 3, art. 1124(4).

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fair process in adjudication is that parties whose rights or interests are affected by the adjudication should have a right of standing in the adjudicative process, to the extent of their affected rights or interests.[25] If an affected party is denied the opportunity to seek standing, the adjudicator would not hear all sides to the dispute and may be unable to consider relevant facts and arguments. ISDS is fundamentally unfair because it does not give this right of standing to all parties affected by the adjudication of foreign investor claims. Instead, ISDS provides a right of standing only to the foreign investor(s) bringing the claim and to the respondent country, represented by its national government.[26] No one else whose rights or interests are affected by the foreign investor's claim can have standing regardless of the extent to which his or her rights or interests are affected.[27]

In its proposal for a TTIP investment chapter, released in November 2015, the European Union took a partial but significant step to address this procedurally unfair aspect of ISDS. The proposal included a right of intervention for any party with a direct interest in the proceeding, albeit limited to the option of supporting either the claimant investor's or the respondent state's position.[28] This proposal went a significant way to addressing the lack of procedural fairness in ISDS. However, it did not find its way into the Vietnam FTA of December 2015 or the revised CETA of February 2016. Thus, there was evidently awareness of the issue within the European Union and a choice made not to address the matter in subsequent agreements. In addition, the European Union has through its subsequent agreements presumably signalled to the United States that it is not firmly committed to this particular reform.

A weaker response to the problem of procedural unfairness, drawing on the U.S. approach to ISDS since the early 2000s, has been to allow ISDS

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[25] *See* GUS VAN HARTEN, GERALD HECKMAN, DAVID MULLAN, JANNA PROMISLOW, ADMINISTRATIVE LAW – CASES, TEXT, AND MATERIALS 73-74 (7th ed., 2015).
[26] *See* CETA, *supra* note 8, art. X.3; Singapore FTA, *supra* note 9, art. 9.14(2)(a) (definition of "disputing parties"); Vietnam FTA, *supra* note 10, art. 2 of ch. II, sec. 3 (definition of "disputing parties").
[27] For an indication of cases in which outside parties were affected by an ISDS proceeding, see Van Harten, *supra* note 12.
[28] *See* TTIP investment ch., *supra* note 7, art. 23 ("The Tribunal shall permit any natural or legal person which can establish a direct and present interest in the result of the dispute (the intervener) to intervene as a third party…").

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adjudicators to grant *amicus* or limited "third person" status in ISDS.[29] This step falls well short of meeting the criterion of a fair process because *amicus* representation does not require an ISDS tribunal to give standing to persons who have a direct interest in the proceeding.[30] Rather, it allows a party to participate in the proceedings in a limited way, only as authorized (if at all) by the arbitrators.[31] Conventionally, *amicus* status was used to permit parties with a useful perspective, but no legal interest, to assist the judge or other adjudicators in understanding the party's perspective. For ISDS to be fair, it would have to ensure a right of standing for all affected parties regardless of how useful the adjudicator thinks their perspective may be.[32]

On this basis, the E.U.'s model of ISDS allows adjudicators to make decisions that affect other parties — whether private actors or public entities — without hearing from them. This unfairness could be addressed, as proposed in the E.U.'s TTIP investment chapter of November 2015, by requiring public notice of ISDS claims and allowing time for other affected parties to apply for standing. In the case of the Vietnam FTA and revised CETA, the partial fix proposed by the European Union for TTIP was omitted. In all agreed texts of the European Union, therefore, ISDS is procedurally unfair.

4. RESPONSE TO THE LACK OF BALANCE IN ISDS

The discussion now turns from the process of ISDS to its overall design, focusing on the formal allocation of substantive rights and responsibilities

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[29] *See* Singapore FTA, *supra* note 9, art. 3 of annex 9-G. This step also appears to have been taken in the CETA and Vietnam FTA by their incorporation of the UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration (art. 4) in CETA, *supra* note 8, art. 8.36 and 8.38(1)(b)(ii); Vietnam FTA, *supra* note 10, art. 20 of ch. II, sec. 3.

[30] *See* Patrick Wieland, *Why the Amicus Curia Institution is Ill-suited to address Indigenous Peoples' Rights before Investor-State Arbitration Tribunals: Glamis Gold and the Right of Intervention*, TRADE, L. & DEV'T 334, 344-5 and 359-60 (2011); *see also* Nigel Blackaby & Caroline Richard, *Amicus Curiae: A Panacea for Legitimacy in Investment Arbitration?*, *in* THE BLACKLASH AGAINST INVESTMENT ARBITRATION 253, 259-266 (Michael Waibel et al eds., 2010).

[31] In actual arbitrations, *amicus* representation has been used rarely and with significant restrictions; *see* Wieland, *supra* note 30, at 341-4.

[32] *See* Eugenia Levine, *Amicus Curiae in International Investment Arbitration: The Implications of an Increase in Third-Party Participation,* 29 BERKELEY J INT'L 200, 208-214 (2011); *see also* ALBERTO SALAZAR, *Defragmenting International Investment Law to Protect Citizen-Consumers: The Role of Amici Curiae and Public Interest Groups* 4-8 (Osgoode Hall Law Sch., Comparative Research in Law & Political Econ., Working Paper No 6, 2013).

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and on the relationship between ISDS and domestic courts. To be balanced in a broad sense, it is suggested that ISDS must incorporate responsibilities for foreign investors that are actionable in the manner of their rights and affirm the state's right to regulate alongside the elaborate rights and protections afforded to foreign investors. This is a formalized version of the notion of balance because, with the exception of the clarity of the state's right to regulate, it does not avert to the content or extent of foreign investor rights and responsibilities.[33] To address in part this limitation of the analysis, I offer in this section a closer assessment of the foreign investor rights envisaged by the European Union in order to demonstrate their breadth and potency. The assessment reveals that some aspects of the characterization of foreign investor rights in the E.U.'s proposed or negotiated agreements are sufficiently broadly framed as to go beyond the U.S. model of ISDS.

4.1. Foreign Investor Rights, Without Responsibilities

In its conventional form, ISDS discriminates in favour of foreign investors and against anyone else who is affected by an ISDS dispute involving a foreign investor and the country against whom the investor has brought a claim. Foreign investors obtain powerful rights and protections but, as a rule, have no correspondingly actionable responsibilities to respect international standards. To make ISDS more balanced in this formal sense, states would need to allow for the use of ISDS to hold foreign investors accountable if they flout labour, environmental, consumer, or other standards in situations where domestic institutions do not offer an effective remedy.

In its approach to ISDS, the European Union has taken no steps to rebalance ISDS in this way in any of its proposed or negotiated agreements. In each agreement, foreign investors would have special access to an exceptionally powerful system of international adjudication — potentially leading to billions of dollars in public compensation — to enforce their wide-ranging rights, without responsibilities that can lead to a compensation order against the foreign investor and that are enforceable in the same process. The resulting imbalance is especially pronounced because none of

[33] For a cautious approach to the issue of foreign investor responsibilities, see PETER T. MUCHLINSKI, MULTINATIONAL ENTERPRISES & THE LAW (2nd ed., 2007).

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the E.U.'s agreements require foreign investors to go to a country's courts or European courts before resorting to ISDS. That is, the agreements abandon the usual duty to exhaust local remedies, where they offer justice and are reasonably available, which applies customarily in international law and at other international courts and tribunals where individuals can bring claims against a country.[34] Building on a Western European and North American legacy of imbalanced ISDS treaties, the E.U.'s approach allows foreign investors to bring ISDS claims against a country without going to the country's courts first, regardless of whether the courts offer justice. Put differently, a foreign investor can bring an ISDS claim without any requirement that the investor explain why it would be unfair to go first to a country's courts in order to resolve its dispute. By implication, the E.U.'s approach and ISDS in general are based on the presumption that domestic courts in all countries fail systemically to offer justice to foreign investors. Similarly, these approaches operate from the premise that ISDS is independent and fair in the manner of a proper court, which it clearly is not for the reasons discussed earlier.

Why should foreign investors be relieved of the usual duty to go to domestic courts without having to show that the courts in question somehow fail to offer justice? One may worry that domestic courts could take too long or are in some other way inadequate to protect foreign investors. If that is a pressing concern, why not replace courts with arbitrators for everyone? Clearly, others — whether foreigners or a country's own nationals — may suffer as much or more than a foreign investor if courts do not offer justice. The question itself points to the radical proposition lying behind ISDS: to replace courts with a special and very powerful adjudicative system available only to foreign investors.

The issue of domestic courts also points to a larger question about the balancing of rights and responsibilities. What if domestic courts are inadequate to protect victims of foreign investors themselves? One can imagine scenarios where a person or community suffers tremendously because of a foreign investor's misconduct. Yet such actors would be limited

[34] *See, e.g.*, SILVIA D'ASCOLI & KATHRIN MARIA SCHERR, *The Rule of Prior Exhaustion of Local Remedies in the International Law Doctrine and its Application in the Specific Context of Human Rights Protection* (European Univ. Inst., Working Paper No. 02, 2007).

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to domestic courts, with no right to initiate an international claim and receive an internationally-enforceable award of compensation. For example, in the era of ISDS, a foreign national who has been tortured by a country's officials cannot bring an international claim against the country, at least without going first to the country's courts.[35] Yet the foreign national *could* bring an ISDS claim if he or she owned assets in the state, thus qualifying as a foreign investor, albeit only to the extent that the torture affected his or her position as an asset owner. In contrast, if a foreign investor's personnel were to torture its domestic employees, with the collaboration of state officials, none of the victimized employees could bring an international claim against the company or its officers, or against the state itself, for failing to protect them, without going first to domestic courts. This illustrates the stark disparity in protection that ISDS offers to foreign investors in comparison to other victims of misconduct.

A limited starting point for recognizing foreign investor responsibilities and rebalancing ISDS would be to allow countries to bring claims against a foreign investor that has initiated an ISDS claim against the country, for the purpose of holding the foreign investor to minimum international standards of conduct. This arrangement would remain formally imbalanced because it would not give states a right, alongside foreign investors, to initiate ISDS proceedings in the first place. Also, it would not give rights to private parties who were harmed by a foreign investor and denied justice in domestic courts. Despite these limitations, there is no sign that even this step has been pursued by the European Union.

In summary, ISDS is premised on a profoundly imbalanced elevation of foreign investor rights and protections over the rights of everyone else. The European Union has endorsed this imbalance by not stipulating equivalently actionable responsibilities for foreign investors and by not incorporating a duty to exhaust local remedies before the foreign investor can bring an ISDS claim asserting its powerful rights. Moreover, as I explain

[35] *See, e.g.*, Convention against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment art. 21 (c) and 22 (4) (b), GA Res. 39/46, annex, 39 U.N. GAOR, Supp. No. 51 at 197, opened for signature Dec. 10, 1984, U.N. Doc. A/39/51 (1984), 1465 U.N.T.S. 85 (entered into force Jun. 26, 1987).

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below, the European Union has in key respects taken an exceptionally expansive approach to foreign investor rights.

4.2. Expansive Scope of Foreign Investor Rights and Protections

The E.U.'s approach, in the proposed TTIP and in the CETA, Singapore FTA, and Vietnam FTA, is based on broadly-framed foreign investor rights and protections. Some of the major features of this approach are outlined in this section, beginning with the breadth of the access to ISDS that is allowed for foreign investors and followed by the flexibility of the language that is used to define the core rights of foreign investors.

4.2.1. Broad Access to ISDS

The E.U.'s approach has been to define the concept of "investment" broadly, consistent with a U.S. model of ISDS. The definitions proposed for the TTIP and adopted in the CETA and FTAs are wide-ranging, giving access to ISDS to asset owners in general. The definitions are not limited, for example, to "investment" in the sense of capital committed to a risky venture with an expectation of profit or some identifiable contribution to the host country's economy.

Among the E.U.'s agreements, there are modest variations on this point. For example, the Singapore and Vietnam FTAs' definitions of investment specifically include "goodwill" and thus are broader on paper than the CETA's definition, which does not.[36] Even so, based on the record of ISDS awards, these textual differences are not as significant as they may appear because other aspects of the definition of investment have been used by arbitrators to capture broad notions of asset ownership. In particular, the CETA definition incorporates the elastic concept of "[e]very kind of asset that an investor owns or controls, directly or indirectly" and the Singapore FTA definition includes "every kind of asset which is owned, directly or indirectly, or controlled, directly or indirectly, by investors".[37]

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[36] *See* Singapore FTA, *supra* note 9, art 9.1(1); Vietnam FTA, *supra* note 10, subsec. 4(p)(vi) of art. entitled "Objectives, coverage and definitions" of ch. I; *see also* CETA, *supra* note 8, art. 8.1 (definition of "investment").

[37] *See* Singapore FTA, *supra* note 9, art 9.1(1); Vietnam FTA, *supra* note 10, subsec. 4(p)(vi) of art. entitled "Objectives, coverage and definitions" of ch. I; *see also* CETA, *supra* note 8, art. 8.1 (definition of "investment").

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The E.U.'s approach is also expansive because it has expressly limited use of the so-called *Salini* criteria.[38] These criteria were adopted by early ISDS tribunals and applied subsequently to orient and limit the concept of investment in investment treaties. The European Union has adopted aspects of the criteria, but only as an optional reference point instead of a requirement for tribunals to consider.[39] To illustrate, the CETA applies only to any asset "that has the characteristics of an investment, which include a certain duration and other characteristics such as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk";[40] while the Singapore FTA applies to any asset "that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, the assumption of risk, or a certain duration".[41] Based on this language, in the CETA, tribunals are required to consider one mandatory characteristic only — "a certain duration" — and the other three *Salini* criteria are listed merely as examples for tribunals to consider. The Singapore and Vietnam FTAs are even more flexible because they list all four of the *Salini* criteria merely as examples for tribunals to consider.[42]

Thus, the European Union has moved away from past approaches to ISDS that applied the *Salini* criteria as mandatory and cumulative elements of the concept of investment. Also, the European Union has dropped entirely one of the *Salini* criteria: the requirement that an asset, to qualify as an investment, must contribute to the development of the host country's economy. By diluting the criteria in these ways, the European Union has put aside limited constraints on the concept of investment that were developed by some ISDS tribunals. In doing so, the European Union effectively has sided

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[38] *See* Salini Costruttori SpA and Italstrade SpA v. Kingdom of Morocco, ICSID Case No. ARB/00/4 (Jul. 23, 2004), 42 I.L.M. 609, para 52. *See also* Fedax NV v Republic of Venezuela, ICSID Case No. ARB/96/3 (Jul. 11, 1997), 37 I.L.M. 1378, para 43.

[39] *See* Omar E. García-Bolívar, *Defining an ICSID Investment: Why Economic Development Should be the Core Element*, INVESTMENT TREATY NEWS (Apr. 13, 2012), http://www.iisd.org/itn/2012/04/13/defining-an-icsid-investment-why-economic-development-should-be-the-core-element/.

[40] *See* CETA, *supra* note 8, art. 8.1 (definition of "investment").

[41] *See* Singapore FTA, *supra* note 9, art. 9.1(1). The Vietnam FTA's definition is essentially the same as the Singapore FTA's on this issue: *see also* Vietnam FTA, *supra* note 10, subsec. 4(p) of art. entitled "Objectives, coverage and definitions" of ch. I.

[42] *See* Singapore FTA, *supra* note 9, art. 9.1(1). The Vietnam FTA's definition is essentially the same as the Singapore FTA's on this issue: *cf.* Vietnam FTA, *supra* note 10, subsec. 4(p) of art. entitled "Objectives, coverage and definitions" of ch. I.

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with other ISDS tribunals that chose not to apply the *Salini* criteria or that treated them as guidelines instead of requirements.[43] In either case, the European Union has endorsed an approach that favours foreign investors, especially large multinationals and very wealthy individuals who are the most able to finance claims, at the expense of the regulatory domain of states. Put differently, when faced with different views among ISDS tribunals on the scope of the definition of investment, the European Union opted to codify the more investor-friendly approach.

Linked to the issue of access to ISDS, the CETA, Singapore FTA, and Vietnam FTA take modest steps to limit ISDS forum-shopping. In particular, the agreements permit an investor to bring a claim only if the investor has "substantial" or "substantive" business operations in its "home" country (i.e. in the jurisdiction of which the investor claims to be a national under the treaty).[44] This limitation on forum-shopping is modest because it does not require the investor to have its headquarters or main base of operations in the home country. Instead, ISDS claims can be brought by multinational companies or individuals with multiple nationalities so long as the company or individual has a sufficient level of business activity in the relevant jurisdiction under the treaty, even if that jurisdiction is not the primary or dominant place of business.

4.2.2. Expansive Version of Fair and Equitable Treatment

In its approach to the vague and, for states, financially risky foreign investor right to "fair and equitable treatment", the European Union appears committed to expanding the power of ISDS adjudicators. The E.U.'s codification of an expansive element, developed by ISDS arbitrators in the past, as part of the right to fair and equitable treatment goes beyond the U.S.

[43] *See* García-Bolívar, *supra* note 39.
[44] *See* CETA, *supra* note 8, art. 8.1 (definition of "enterprise of a Party"); *see also* Singapore FTA, *supra* note 9, art. 9.1(4); *see also* Vietnam FTA, *supra* note 10, subsec. 4(c) of art. entitled "Objectives, coverage and definitions" of ch. I.

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model or, for that matter, Canada's past approach.[45] It therefore seems clear that the Commission pressed for this expansive shift.

As background, the concept of fair and equitable treatment is the most widely-invoked right in treaty-based ISDS.[46] Arbitrators have been creative in giving different readings — usually expansive — to the concept.[47] In the North American approach to ISDS since the early 2000s, an effort was made to rein in ISDS arbitrators by limiting the concept to the meaning that is customarily associated with the minimum standard of treatment in international law.[48] This attempt to rein in ISDS arbitrators has had only limited success, since the 2000s, as arbitrators subsequently adopted the interpretive device of relaxing the standard of proof a foreign investor must satisfy — when arguing for an expansion of the customary international minimum standard — by relieving the investor of the usual onus to provide evidence of state practice and opinio juris in support of an evolution of customary international law.[49]

Compared to the North American effort to constrain ISDS arbitrators on this point, the European Union has taken a more expansive tack. None of the E.U.'s proposed or negotiated agreements restrict ISDS adjudicators to applying the customary international minimum standard. Instead, the E.U.'s agreements allow ISDS adjudicators to apply some of the leading expansive versions of fair and equitable treatment adopted in ISDS tribunal decisions since the late 1990s.[50] Thus, the European Union has endorsed a key feature of ISDS arbitrators' creative expansion of foreign investor rights and protections. This part of E.U.'s approach is perhaps the most important

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[45] Canada's treaties providing for ISDS have followed the U.S. approach by clarifying, since the early 2000s when the issue was raised in response to early NAFTA awards, that fair and equitable treatment is limited to the meaning of the minimum standard of treatment in customary international law. That said, in some of Canada's treaties, this clarifying language is undermined by a most-favoured-nation treatment loophole. *See* Gus Van Harten, *The Canada-China FIPPA: Its Uniqueness and Non-Reciprocity*, 51 CANADIAN YEARBOOK OF INT. L. 3, 27-34 and Annex 1 (2013).
[46] *See* Van Harten, *supra* note 2, at 101-103.
[47] *See* Van Harten, *supra* note 2, at 102.
[48] *See* Free Trade Agreement, Dom. Rep.-Cent. Am.-U.S., art. 10.5(2), 19 U.S.C.S. § 4011 (LexisNexis, 2005).
[49] *See* Matthew C. Porterfield, *A Distinction Without a Difference? The Interpretation of Fair and Equitable Treatment Under Customary International Law by Investment Tribunals*, INVESTMENT TREATY NEWS (Mar. 22, 2013), https://www.iisd.org/itn/2013/03/22/a-distinction-without-a-difference-the-interpretation-of-fair-and-equitable-treatment-under-customary-international-law-by-investment-tribunals/
[50] *See* Van Harten, *supra* note 2, at 102.

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example of how the European Union has varied from the U.S. model and, in this case, the European Union chose a more investor-friendly, expansive direction.

The E.U.'s approach to fair and equitable treatment is also expansive because it defines that concept using a list of components.[51] The list is essentially the same in each of the E.U.'s agreements. It includes the components of denial of justice, fundamental breach of due process, manifest arbitrariness, and abusive or bad faith conduct. The CETA and Vietnam FTA add the further component of targeted discrimination on manifestly wrongful grounds. Any single component on the list can give rise to a breach of the fair and equitable treatment standard and, in turn, an order of compensation for the foreign investor.

By using this list-based approach to describe fair and equitable treatment, the E.U.'s approach might appear to limit the range of definitions that ISDS adjudicators can give to the overall right. Yet the E.U.'s agreements have a loophole; to varying degrees, they do not make it clear whether the list of the components is exhaustive.[52] For example, the CETA does not state that the right to fair and equitable treatment is breached "only" when a component on the list has been breached.[53] This lack of precision gives an opportunity for ISDS adjudicators to supplement the list by reading novel and expansive components into the right to fair and equitable treatment, as they have done frequently since ISDS claims began to explode in the late 1990s.

Perhaps most importantly, the European Union has taken an expansive approach to fair and equitable treatment by incorporating into the right a foreign investor's "legitimate expectations". The notion of legitimate expectations, as an arbitrator-created part of the right to fair and equitable treatment, is among the most novel and expansive features that arbitrators have added to ISDS. Often, they have relied on the notion of legitimate expectations to justify awards of compensation for foreign investors. In the E.U.'s agreements, the idea of legitimate expectations is incorporated in

[51] *See* CETA, *supra* note 8, art. 8.10(2); *see also* Singapore FTA, *supra* note 9, art. 9.4(2); *see also* Vietnam FTA, *supra* note 10, art. 14(2) of ch. II.
[52] *See* CETA, *supra* note 8, art. 8.10(2); *see also* Singapore FTA, *supra* note 9, art. 9.4(2) and (3); *see also* Vietnam FTA, *supra* note 10, art. 14(2) and (3) of ch. II.
[53] *See* CETA, *supra* note 8, art. 8.10(2).

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different ways. For example, the Singapore FTA is more expansive than the CETA and Vietnam FTA on this point because the Singapore FTA includes legitimate expectations as part of the list of components of fair and equitable treatment,[54] whereas the CETA and Vietnam FTA allow arbitrators to consider legitimate expectations when applying the listed components of fair and equitable treatment.[55] Even so, all of the E.U.'s agreements are more expansive than the United States' and Canada's approach because they invite ISDS adjudicators to perform a flexible analysis of the foreign investor's expectations that enhances the regulatory and financial risks of ISDS for states.

4.2.3. Other Foreign Investor Rights

Other aspects of the E.U.'s approach to foreign investor rights mostly track the U.S. model. For example, the E.U.'s proposed or negotiated agreements include foreign investor rights to full protection and security,[56] compensation for losses[57] and for expropriation,[58] and free capital transfers.[59] The agreements do not vary markedly in these respects[60] and the rights in question are typical of a U.S. model.

To illustrate further, the E.U.'s approach to the right to full protection and security follows the U.S. model by limiting the concept to the physical security of foreign investors and their investments.[61] The E.U.'s approach likewise includes a clause, consistent with the U.S. model, precluding ISDS adjudicators from finding a breach of full protection and security or fair and

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[54] *See* Singapore FTA, *supra* note 9, art. 9.4(2)(e).
[55] *See* CETA, *supra* note 8, art. 8.10(4); *see also* Vietnam FTA, *supra* note 10, art. 14(6) of ch. II.
[56] *See* CETA, *supra* note 8, art. 8.10(1); *see also* Singapore FTA, *supra* note 9, art. 9.4(1); *see also* Vietnam FTA, *supra* note 10, art. 14(1) of ch. II.
[57] *See* CETA, *supra* note 8, art. 8.11; *see also* Singapore FTA, *supra* note 9, art. 9.5; *see also* Vietnam FTA, *supra* note 10, art. 15 of ch. II.
[58] *See* CETA, supra note 8, art. 8.12; *see also* Singapore FTA, *supra* note 9, art. 9.6; *see also* Vietnam FTA, supra note 10, art. 16 of ch. II.
[59] *See* CETA, *supra* note 8, art. 8.13; *see also* Singapore FTA, *supra* note 9, art. 9.7; *see also* Vietnam FTA, *supra* note 10, art. 17 of ch. II.
[60] One significant variation is that a carve-out from the right to make free capital transfers in the Singapore FTA, *supra* note 9, art. 9.7(2), appears broader than the comparable carve-out in the CETA, *supra* note 8, art. 8.13(4), and NAFTA, *supra* note 3, art. 1109(4), because, in the Singapore FTA, the carve-out includes exceptions on social security, public pensions, and taxation.
[61] *See* CETA, *supra* note 8, art. 8.11(5); *see also* Singapore FTA, *supra* note 9, art. 9.4(4); *see also* Vietnam FTA, *supra* note 10, art. 14(4) of ch. II.

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equitable treatment based on an assessment that a country has breached a provision elsewhere in the trade agreement or in another international agreement.[62] Like the approach taken in the U.S. model, these clauses constrain aspects of the adjudicative discretion in ISDS against a backdrop of expansive interpretations by ISDS arbitrators. Even so, they still carry a complex but significant risk due to the foreign investor right to most-favoured nation (hereinafter MFN) treatment.[63]

Furthermore, in the Singapore FTA and Vietnam FTA, but not the CETA, the European Union has negotiated an "umbrella clause" as part of the suite of rights for foreign investors. An umbrella clause is far-reaching because it incorporates a host country's other obligations into the foreign investor's rights at the treaty level and thus subjects those other obligations to ISDS.[64] For example, the Singapore FTA states that a country must not "frustrate or undermine" a specific and clear commitment in a contractual obligation owed to a foreign investor.[65] This version of an umbrella clause is more limited than umbrella clauses in some other treaties, but it is still potentially very expansive because it allows ISDS to be constituted as a parallel enforcement system for the state's contracts with foreign investors. This aspect of the Singapore and Vietnam FTAs also goes beyond the most commonly invoked example of the U.S. model, NAFTA, which does not have an umbrella clause, although many U.S. bilateral investment treaties include such clauses.[66] On this point, the E.U.'s approach in its FTAs demonstrates further that the European Union has accepted an expansive version of foreign investor rights.

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[62] *See* CETA, *supra* note 8, art. 8.10(6); *see also* Singapore FTA, *supra* note 9, art. 9.4(6); *see also* Vietnam FTA, *supra* note 10, art. 14(7) of ch. II.

[63] The risk is that an agreement's limiting provisions for other foreign investor rights can be undermined by the agreement's approach to (MFN) treatment. The CETA, for example, uses qualified language when it purports to preclude the importation into the CETA — using the principle of MFN treatment — of additional substantive rights of foreign investors in treaties with third states. For a more detailed explanation of the point *see* G. VAN HARTEN, *Comments on the European Commission's Approach to Investor-State Arbitration in TTIP and CETA* 10-11, 20, 25 (Osgoode Hall Law Sch. of York Univ., Working Paper No. 59, 2014).

[64] *See* Singapore FTA, *supra* note 9, art. 9.5(5); *see also* Vietnam FTA, *supra* note 10, art. 14(5) of ch. II.

[65] Singapore FTA, *supra* note 9, art. 9.5(5).

[66] Katia Yannaca-Small, *Interpretation of the Umbrella Clause in Investment Agreements*, *in* INTERNATIONAL INVESTMENT LAW: UNDERSTANDING CONCEPTS AND TRACKING INNOVATIONS 115 (2008).

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Another example of the E.U.'s willingness to accept an expanded version of foreign investor rights arises from its approach to ISDS and financial services. Compared to NAFTA, the CETA expands the role of ISDS in the agreement's chapter on financial services.[67] This expansion leads to a complex interaction between the CETA's investment and financial services chapters, a close analysis of which is beyond the scope of this paper. The key is that the CETA goes beyond the North American model, as captured by NAFTA, which extends ISDS to its chapter on financial services to a lesser degree than the CETA does.[68] As a result, the CETA expands states' obligations when regulating financial institutions by importing more foreign investor rights — including fair and equitable treatment and full protection and security — from the investment chapter into the financial services chapter.[69] In this respect, the CETA is a win for global banks at the expense of financial regulators and anyone whose interests the regulators protect.[70]

In other areas, the E.U.'s approach is not as expansive as the U.S. model. An example is the U.S.-devised prohibition on performance requirements for foreign investors. A prohibition on performance requirements typically blocks countries from requiring foreign investors to use local goods or local suppliers, or to transfer technology, as conditions for being allowed to invest in a country. The prohibition on performance requirements in NAFTA, for example, has been used successfully by U.S. companies to resist research and development requirements in Canada's offshore oil sector.[71] In the U.S. model, the prohibition on performance requirements is subject to ISDS and state-state enforcement.[72] The CETA, by comparison, has a prohibition on performance requirement that is subject to

[67] *See* CETA, *supra* note 8, art. 13.2(3) and (4).
[68] *See* NAFTA, *supra* note 3, art. 1401(2).
[69] *See* CETA, *supra* note 8, art. 13.2(3) and (4).
[70] The CETA and FTAs also have special provisions on foreign investor rights in the context of debt restructuring or a monetary crisis: *see, e.g.*, CETA, *supra* note 8, annex 8-B; *see also* Singapore FTA, *supra* note 9, artt. 9.7(3) and 17.9; *see also* Vietnam FTA, *supra* note 10, annex on Public Debt. An analysis of these provisions is beyond the scope of this paper, although they all raise the broad concern that sovereign decisions during a financial crisis would continue to be subject, to varying degrees, to review in ISDS.
[71] Mobil Investments Canada Inc. and Murphy Oil Corporation v. Canada, No. ARB(AF)/07/4, ITALAW (Ont. Sup. Ct. May 22, 2012).
[72] *See, e.g.*, NAFTA, *supra* note 3, art. 1106.

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state-state enforcement only, not ISDS.[73] On this issue, the CETA resembles the substantive obligation in the U.S. model but does not allow for its enforcement in ISDS.

In addition, the CETA includes market access rights for foreign investors by including the terms “establishment”, “acquisition”, and “expansion” in the list of investment activities to which the treaty’s national treatment obligation applies.[74] By comparison, the Singapore and Vietnam FTAs limit national treatment to post-establishment activities of foreign investors.[75] Each agreement also has extensive reservations and schedules that remove some activities from the obligation to provide no less favourable treatment to foreign investors than what is provided to domestic investors.[76] In this way, the European Union went further in its market access commitments in the CETA than in the Singapore or Vietnam FTAs. Even so, the European Union did not go as far in any of the three agreements as the U.S. model would typically go by including market access rights and subjecting them to ISDS. To illustrate, in the CETA, market access is limited to state-state dispute settlement[77] whereas in the Singapore FTA it is stated that the investment chapter applies to investments “made . . . in accordance with the applicable laws”, which is a conventional device for excluding market access rights.[78]

The E.U.’s agreements, again following the U.S. model, also expressly authorize the states parties to issue interpretations of the treaty that are binding on ISDS adjudicators.[79] This mechanism is potentially useful to rein in arbitrator adventurism. That said, it has been available for over 20 years under NAFTA and has been used only twice.[80] Due to the degree of governmental mobilization and consensus that is required to implement the

[73] *See* CETA, *supra* note 8, art. 8.5.
[74] *See* CETA, *supra* note 8, art. 8.6(1).
[75] *See* Singapore FTA, *supra* note 9, art. 9.3(1); *cf.* Vietnam FTA, *supra* note 10, art. 3(2) of ch. II.
[76] *See, e.g.*, CETA, *supra* note 8, art. 8.15; *see also* Singapore FTA, *supra* note 9, art. 9.3(2); Vietnam FTA, *supra* note 10, art. 3(3) of ch. II. A comparative analysis of these reservations and schedules is beyond the scope of this paper.
[77] *See* CETA, *supra* note 8, art. 8.4.
[78] *See* Singapore FTA, *supra* note 9, art. 9.2(1).
[79] *See* CETA, *supra* note 8, art. X.27(2); *see also* Singapore FTA, *supra* note 9, art. 9.22(3).
[80] *See* NAFTA Free Trade Commission, *Notes of Interpretation of Certain Chapter 11 Provisions* (Jul. 31, 2001),http://www.international.gb.ca/trade-agreements-accords-commercieux/topics domaines/disp-diff/NAFTA-Interrpr.aspx.

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mechanism, it is not an effective limit to ISDS adjudicator power. Other aspects of the CETA and FTAs also indicate, as discussed earlier, that the European Union accepts key aspects of ISDS arbitrators' past expansive interpretations of foreign investor rights, especially for the notion of legitimate expectations as part of the right to fair and equitable treatment.

4.3. Affirmation of the Right to Regulate

ISDS is imbalanced because it delivers wide-ranging and highly-enforceable foreign investor rights with corresponding responsibilities for countries. The essence of these responsibilities is the profound obligation of states to submit to ISDS adjudicator power and pay compensation as ordered by the adjudicators, where a majority of the tribunal decides the state did not, for example, treat a foreign investor fairly and equitably, live up to the investor's legitimate expectations, pay enough compensation after denying a permit or introducing a regulation, refrain from treating local investors more favourably than foreigners, or allow a foreign investor to transfer capital in or out of the country.[81] On the other hand, treaties allowing for ISDS typically lack a clear (or any) affirmation of the state's right to regulate as a counter-balance to foreign investor rights and protections. Investment treaties could affirm this right of the state effectively, alongside the state's responsibilities.[82] That is, the right could be described clearly in the treaty, without broad or ambiguous limitations, so as to limit the state's obligations as a whole concerning protection of foreign investors.[83] Yet the treaties rarely if ever do so.

As a response to this lopsided situation, the E.U.'s approach has incorporated into the CETA and Vietnam FTA a broadly worded clause that affirms the right to regulate.[84] This clause gives the ISDS adjudicators — if so inclined — an interpretive device to weigh foreign investor rights against the

[81] *See, e.g.*, CETA, *supra* note 8, art. 8.6, 8.10, 8.12, and 8.13.
[82] *See* J ANTONY VANDUZER, PENELOPE SIMONS & GRAHAM MAYEDA, INTEGRATING SUSTAINABLE DEVELOPMENT INTO INTERNATIONAL INVESTMENT AGREEMENTS: A GUIDE FOR DEVELOPING COUNTRIES 287-398 (2012).
[83] *See, e.g.,* Convention for the Protection of Human Rights and Fundamental Freedoms, Nov. 4, 1950, Eur TS 5 and 213 UNTS 222 (entered into force Sept. 3, 1953); *see also* Final Act of the United Nations Conference on Trade and Employment: Havana Charter for an International Trade Organization, U.N. Conference on Trade and Employment, U.N. Doc 1948 II.D.4.1 (1948).
[84] *See* CETA, *supra* note 8, art. 8.9(1); *see also* Vietnam FTA, *supra* note 10, art. 13bis of ch. II.

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safeguarding of regulatory space for legislatures, governments and courts. Both the CETA and Vietnam FTA are worded in clearer terms than the comparably weak clause proposed by the European Union for the TTIP investment chapter.[85] Their affirmations of the right to regulate are an important improvement over the omission of the right in earlier versions of the CETA and a step toward formal balance in ISDS, even though none of the E.U.'s agreements take steps to establish actionable responsibilities for foreign investors.

In contrast, the Singapore FTA follows the usual ISDS model by not affirming the right to regulate in the investment chapter. Instead, the right is noted in aspirational preambular and other chapters of the FTA, signaling that the right is affirmed only for purposes of FTA chapters other than the investment and financial services chapters. In particular, in the Singapore FTA, the right to regulate is affirmed in the agreement's chapters on services and the environment,[86] creating an inference that the right was intentionally excluded from the FTA's separate investment and financial services chapters. The Singapore FTA thus falls well short of balancing the right to regulate, even in a formal sense, against the state's responsibilities to protect foreign investors.

Yet the European Commission has claimed that the approach to ISDS in the Singapore FTA and earlier versions of the CETA safeguards the right to regulate through a series of textual clarifications drawn mostly from the post-2000 U.S. model of ISDS.[87] For example,[88] the CETA had (and still has) moderating language for the foreign investor right to generous compensation for regulations that are viewed by the arbitrators as indirect expropriation.[89] This language supports the state's regulatory discretion as weighed against

[85] *See* TTIP investment ch., *supra* note 7, art. 2(1). *See also* G. VAN HARTEN, *Key Flaws in the European Commission's proposals for foreign investor protection in TTIP* 4-5 (Osgoode Hall Law Sch. of York Univ., Working Paper No. 16, 2016).

[86] *See* Singapore FTA, *supra* note 3, art. 8.1(2) and art. 13.2.

[87] *See, e.g.*, TTIP consultation text, *supra* note 7, at 2.

[88] The other main examples relate to the CETA and Singapore FTA's language on fair and equitable treatment, which is discussed in more detail below, and to the use of exceptions, reservations, and carve-outs. For a discussion of why the Commission's approach to these issues is problematic or misleading, from the perspective of balancing the state's right to regulate, see Gus Van Harten, *Reforming the System of International Investment Dispute Settlement, in* ALTERNATIVE VISIONS IN THE INTERNATIONAL LAW ON FOREIGN INVESTMENT: ESSAYS IN HONOUR OF M. SORNARAJAH 103 (Chin Leng ed., 2016).

[89] *See* CETA, *supra* note 8, annex 8-A; *see also* Singapore FTA, *supra* note 9, annex 9-A; *see also* Vietnam FTA, *supra* note 10, annex on expropriation.

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the state's obligation to compensate for direct or indirect expropriations, although it has major limitations.[90] For example, the moderating language does not apply to all foreign investor rights in the treaty, including the one – fair and equitable treatment – that is most frequently used by arbitrators to order public compensation for foreign investors. The E.U.'s approach also maintains interpretive power in the hands of ISDS adjudicators who have very rarely accepted principles of generalized balancing to limit foreign investor rights by reference to the right to regulate or rights of other actors.[91] If the Commission wanted to affirm the right to regulate, it would have to do so clearly for all foreign investor rights and protections and in all areas of state decision-making.

Lastly, there is a notable innovation in the CETA relating to the right to regulate. The CETA has a novel clause on arbitrators' power to order compensation for foreign investors. It is stated that, when calculating monetary damages against a country, the arbitrators shall reduce the damages to account for "any . . . repeal or modification of the measure".[92] In this way, the CETA appears to endorse expressly the incentives for states to change their decisions, in order to appease foreign investors who have brought an ISDS claim, as a means to limit the state's exposure to liability at the hands of ISDS adjudicators. Put differently, this CETA clause acknowledges and appears to be a step toward institutionalizing the dynamic of regulatory chill in ISDS.

5. CONCLUSION

The European Union has demonstrated that it is willing to accept a deeply flawed form of ISDS based on the conventional model pushed by Western European countries and the United States in their relations with developing and transition countries. That model of ISDS lacks judicial independence, procedural fairness, and formal balance in the allocation of rights and responsibilities.

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[90] *See, e.g.*, GUS VAN HARTEN, SOLD DOWN THE YANGTZE: CANADA'S LOPSIDED INVESTMENT DEAL WITH CHINA (2015).
[91] *See* Van Harten, *supra* note 2, at 89-104.
[92] CETA, *supra* note 8, art. 8.39(3).

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In the revised CETA and Vietnam FTA, but not the Singapore FTA, the European Union has taken partial but significant steps to address the lack of independence in ISDS. The European Union also moved in the proposed TTIP investment chapter to address in part the lack of fair process in ISDS, though it did not follow through with these proposed changes in the CETA or the Vietnam FTA. Furthermore, the European Union has adopted broadly-framed foreign investor rights based mostly on the U.S. model and on an especially expansive version of the frequently-invoked right to fair and equitable treatment. These broad rights are not accompanied by equivalently actionable responsibilities for foreign investors or by a requirement that foreign investors resort to domestic courts, where they offer justice, before bringing an ISDS claim. As a more positive but still limited step toward formal balance, the state's right to regulate is affirmed in the investment chapter of the CETA and the Vietnam FTA (but not the Singapore FTA).

Viewed alongside the proposed TTIP, the E.U.'s approach in these other agreements should be understood as an effort to expand massively the role of ISDS in state decision-making.[93] The pending expansion of ISDS can be illustrated approximately by considering the scope of the foreign-owned assets currently covered by ISDS. Using the U.S. economy as a proxy, for example, TTIP alone would extend ISDS coverage of foreign direct investment (FDI) by about 300%, compared to current coverage under existing U.S. treaties allowing for ISDS. That is, TTIP would cover 50 to 60% of inward and outward FDI of the United States, whereas current treaties cover 15 to 20%. Besides TTIP, other treaties pursued by the European Union or the United States — especially the CETA and Trans-Pacific Partnership – would expand ISDS to a point where it covers the great majority of FDI in the world.

Domestic investors and citizens and other foreign nationals are disadvantaged in ISDS, relative to foreign investors. They face the usual risks of democracy, regulation, and courts in the usual ways: by taking part in the

[93] These approximate figures were calculated based on existing investment treaty coverage of country-by-country inward and outward FDI flows for the U.S. in 2012 from the data provided in Organization for Economic Cooperation and Development [OECD], StatExtracts: FDI flows by partner country, http://stats.oecd.org/Index.aspx?DataSetCode=FDI_FLOW_PARTNER. The figures do not account for the possibility of forum-shopping by foreign investors which is difficult to measure and handled in different ways by arbitrators and existing treaties, but which could expand existing ISDS coverage.

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democratic process, by lobbying or protesting, by buying insurance, by bargaining for strong dispute settlement clauses in contracts with government, or by going to court. Foreign investors can still do all these things too, but with ISDS they have the added weapon of an exceptionally-powerful right to sue countries at the international level. Any proposal to grant special privileges, backed by public funds, to a group of economic actors — here, typically the largest and wealthiest in the world — calls at least for a compelling justification based on clear evidence of public benefit. The absence of this justification and evidence has been a key omission in European Union's current pursuit of a greatly expanded role for ISDS.[94]

[94] The most important agreements in this expansion would be the pending U.S.-led Trans-Pacific Partnership (TPP), the proposed TTIP, a proposed E.U.-China bilateral investment treaty, the CETA, and, for Canada, the Canada-China Foreign Investment Promotion and Protection Agreement (FIPA), which entered into force in 2014.