



# A comparison of the development and common objectives of the legislation of the capital markets of the USA and the EU from the beginning of the 20<sup>th</sup> century

Pavel Datinský\* 

\* Ph.D student at Masaryk University, Faculty of Law, Department of Financial Law and Economics. E-mail: [datinsky.pavel@gmail.com](mailto:datinsky.pavel@gmail.com)

## Abstract

This paper deals with the historical development of the legislation of the capital markets of the USA and the EU. It is divided into two parts: the general part contains a brief history of the development of the capital market in this context and I identify several milestones that had a significant impact on the development of the capital markets. The special part, first dealing with the development of the legislation of the capital market in the USA from the Great Depression to date and further by the development of the EU capital market from the foundation of the European Economic Community in 1957 to the implement of the MIFID 2 Directive and MIFIR Regulation, concludes with a comparison of both legislative systems and their common objectives and the interests pursued by individual regulations. The main sources for this paper are in particular the relevant laws regulating the area in question, Czech and foreign scientific papers on the given topic and online economic platforms.

## Keywords

capital market, European Union, investment services, investor protection, prudential requirements.

## 1 Introduction

The financial market of each individual state within the market economy is a crucial and indispensable factor, influencing the functioning of its entirety, as it enables the allocation and redistribution of free financial resources, from the segments of the market with a surplus to those with a deficit. The financial market may be characterised as a sum of relations, entities, instruments, and institutions, which enable the transfer of temporarily free capital on the basis of demand and supply, which leads to the financing of predominantly private economic activities by the private sector itself, which has a positive impact on society as a whole.

Demand on the financial market is represented by a segment with a deficit of capital, which needs it and, as a rule, offers a certain form of consideration for its provision. Entities found in the deficit segment are, as a rule, entrepreneurs who need the capital in order to undertake certain economic or business activities but lack sufficient capital for it. They shall be referred

to herein as issuers. Entities found in the surplus segment are, as a rule, households or other entrepreneurs who are not able to spend all their free capital on their own needs and are eager to provide it temporarily to the deficit entities for a pre-agreed consideration, which is to motivate the investors to provide their capital to the issuers (de Haan et al., 2012, 14–16). Such consideration most often takes the form of an interest-bearing investment, shares in the issuer or a combination of both. The bonding arrangement between the issuer and the creditor is later included in the so-called Investment instrument (Veselá, 2019, 22–28; Pearce & Barnes, 2006, 4–6).

The higher the motivation of the investor, the more capital he will provide to the issuer, as the investor's reward will be higher and more attractive. Conversely, the issuer is interested in providing the lowest reward in order to receive the investor's capital for the lowest price. As far as the interests of the two parties, i.e. those of the issuer and the investor, are different, they however still provide mutual performance to one another, so it is beneficial to the healthy functioning of the whole transaction to ensure it is properly regulated, which will set the boundaries and rules for its implementation and the means of protecting both parties from any undesirable behaviour by the other party.

Alongside the different interests of the investor and the issuer, it is essential to take into account the typical investment risks connected to every investment and posing a threat to the investor, who should diligently consider such risks before making an investment (Rejnuš, 2014, 201–206). According to the extent of the potential risk and the promised future reward, the investor then makes decisions as to how much capital to provide to the issuer, if at all. In practice, this means that the riskier the investment for the investor, the more attractive the promised reward and vice versa.

For the investor to make a rational decision, it is nevertheless indispensable for him to be informed of all relevant facts in a clear, genuine, and non-misleading way to make his investment decision on the basis of high-quality information, otherwise, the investor runs a risk of making the wrong decision and expecting their investment to have features and risk levels that the given instrument in fact does not have<sup>1</sup>. If the investor incurs a loss he could not predict, he may also lose his trust in that financial market and, in an extreme case, may even lose any interest in investing his capital in the market ever again. Such a scenario on a larger scale has far-reaching implications, as if the segment with surplus capital loses their trust, it may further lead to the restricted functioning of the capital market as a whole or even to its complete halt (Bodie et al., 2014, 5–8).

Various negative situations in the capital markets have been occurring ever since they emerged<sup>2</sup> and it would not be much of an overstatement to say that it is these negative events that have positively influenced the development of capital markets. Even in the Middle Ages, when trade in capital or short-term securities, notes of hand, or commodities knew almost no regulation, in times of crisis a sovereign authority figure stepped into this segment of the internal market and mitigated the consequences of the crisis on society by adopting appropriate rules of conduct (laws) (Allen & Gale, 2007, 1–24). It is quite apparent, even in modern history, that as a rule, innovative and ground-breaking regulations only came after significant crises in capital markets that revealed their existing shortcomings (Pavlát et al., 2003, 57–112; de Haan et al., 2012, 22–23).

The given work provides an analysis and presentation of selected historical events that shaped the trade in capital in leading states of the western world, from the Middle Ages to date and demonstrates crucial historical moments that led to the adoption of ground-breaking and

---

<sup>1</sup> More at: de Haan et al. (2014, 16–22).

<sup>2</sup> F.e. the Tulips Crisis in 16<sup>th</sup> century in Netherlands or the South sea “bubble” in 17<sup>th</sup> century in England.

innovative legislation, the aim of which was to improve the functioning of the capital market. In the chapters on the development of legislation on modern capital markets, there will first be an analysis of the legislation of the market in the United States of America, as the world leader in this sphere, followed by an analysis of European legislation from the foundation of the European Economic Community to date. I shall later compare and define the two different systems in relation to the common primary interests and spheres that are regulated.

## 2 A brief history of capital markets

The origins of the capital market go back to the Middle Ages. Many port towns, were important trade centres, with markets selling domestic and foreign goods. Traders conducted financial transactions in different currencies and ensured their commitments with notes of hand that resemble present-day promissory notes. They were used as a means of payment since many traders did not bring much money to the markets for security reasons, as they were afraid of being robbed. Those notes of hand were then informally and spontaneously traded and exchanged between individual traders. The first records of such trade encounters for the purpose of these transactions come from 12<sup>th</sup> century Italy.

The gradual expansion of trade in notes of hand given by traders led to the growing institutionalisation of markets and, around the 15<sup>th</sup> century, there appeared stock exchange societies that united registered traders who, in a more or less organised fashion, traded from brick and mortar buildings, which gave rise to the first European stock exchanges where, in addition to securities (notes of hand) there was trade in goods and foreign currencies. In 1409, a stock exchange was founded in Bruges in what was then Flanders, later in French Lyon, German Hamburg, and later the still standing if several times rebuilt Royal Exchange in London (de Haan, 2012, 51–57).

An important milestone in the trade in securities was the foundation of the Amsterdam stock exchange in 1608, known today as EURONEXT AMSTERDAM,<sup>3</sup> which for the first time began trading in participating securities, namely those that entitle their holders to participate in the company that issues them; in other words, shares. The first joint-stock companies were founded, though not only in Holland, in order to develop international trade with India. Colonisation developed the trade in goods from overseas, in particular in colonising countries, England, France, and Spain, which grew significantly rich thanks to such imports. The first stock exchange in the Austrian Empire was founded by the patent of Maria Theresia as of 14 July 1771 and securities in the form of government bonds in particular were traded there (Veselá, 2011, 47–52).

The history of the financial market in Germany was significantly influenced by Mayer Am-schel Rothschild, who, as a gifted trader in clothes and coins, wisely diversified his investment portfolio and founded the Rothschild banking house in Germany. The three Rothschild sons later left Germany and founded banking houses in Paris, London and Vienna, and the name of Rothschild is linked to investment banking to this day (Bouvier, 2022). More significant trade in the German capital market began in the second half of the 19<sup>th</sup> century after the unification of Germany (Musílek, 2011, 13–15).

With the development of industrial production and capitalism by the end of the 18<sup>th</sup> century, there appeared the first stock exchanges that resemble those of the present day – in 1792 the New York Stock Exchange was founded, which initially traded in bonds of the federal govern-

---

<sup>3</sup> Online: <https://www.euronext.com>

ment that used them to finance their debts from the American War of Independence. With the passage of time, there was more and more trade in corporate shares, understandably supported by the dynamic development of industry, in particular in the USA, but also all around the world.

Stock exchange trade was not regulated until the end of the 19<sup>th</sup> century except for autonomous, non-governmental rules of conduct set by stock exchange corporations and applicable to their members. Public regulation was limited to the authorisation of stock exchange activities as such; it had nothing to do with setting relations established by participating in the stock exchange. The first attempts to regulate them appear at the end of the 19<sup>th</sup> century (Veselá, 2011, 61–77).

During the First World War, capital markets stagnated and industry focused on armaments, and European states were heavily in debt due to the high costs of warfare. Post-war development was characterised by the renewed functioning of the capital market, stabilisation of the value of individual states' currencies and the restart of industrial development and private financing of entrepreneurs via the stock exchange. New York and London became the main global financial centres. Economic growth, supported by private financing in securities exchange, lasted until 1929, when a major economic crisis occurred and the New York Stock Exchange crashed, which negatively affected capital market activities up until the Second World War (Hsu, 2017, 17–38). Investors lost a great deal of their assets, many national economies collapsed and great numbers of people, including disappointed investors, blamed the capitalist and democratic model of government for it, which also led to the growing power and influence of communism and fascism (Pavlát et al., 2003, 68–72).

The Second World War copied the First World War when it comes to its impact on the capital markets; industrial development stagnated except for the development of armaments that states financed through international loans from the USA in particular, not at all from the private sector, by means of selling securities in the securities exchange. After the Second World War, capital markets stabilised again and the economies of several states began to function in their traditional way. However, with the post-war rise of communism in Eastern European states and the transition to the centrally planned economy, the capital market in those countries practically ceased to exist. Such states were Czechoslovakia, East Germany, Hungary, Poland, Romania, Bulgaria, Yugoslavia and Albania, and, of course, the Soviet Union. The capital markets of these states were thus frozen until the end of the communist regime and their regular functioning was renewed after the transition to the market economy, which took place at the beginning of the 90s, after an almost 50-year pause (Veselá, 2011, 47–52).

During this pause in the Eastern bloc, the western world still functioned according to the market model of the economy and capital markets were developing, in particular in the USA, where there was a continuous growth of the national economy during the fifties and sixties and alongside with it grew corporations financed by the private sector, which brought profit to investors and increased the trust of investors in the capital market as a whole (Hsu, 2017, 39–56). Alongside the development of the capital market and the increase in investors' trust, there was increased interest from investors from all classes of society, who had not participated in the capital market until that time, in particular small investors who invested capital on a small scale.

It was not just the arrival of the new type of investors that caused the significant growth of investment funds that connected the assets of many small investors and its collective investing in the capital markets. These funds gradually appeared in the whole western world. In the fifties, there appeared open-ended mutual funds in France, the so-called SICAVs (Sociétés d'investissement à capital variable) followed by Scotland and the whole Great Britain. It is worth noticing, though, that first funds in Great Britain appeared significantly earlier, when the

Foreign and Colonial Government Trust was founded in 1868, followed by the Massachusetts Investors Trust of Boston in the USA in 1924, which was the first so-called open-ended mutual fund in history and which operates to this day as one of the biggest funds in the world. From the end of the Second World War to 1990, the number of investment funds around the world multiplied more than thirty-fold, from the initial 73 funds in 1945 to 2,362 funds in 1990 and their managed assets reached 570 billion dollars by 1990. This number only includes stock and bond funds though, not money-market funds (Liška & Gazda, 2004, 321–325).

Up to the 1980s, stock exchanges all over the world operated as bricks and mortar buildings where traders physically came to buy securities, which entailed a number of restrictions. What significantly reformed the stock exchange trade all over the world was the spread of the internet and the development of IT and communication technologies. This connected all the world's stock exchanges, gave rise to online trade and mainly remote trade without any territorial limitations. This factor had a significant impact on the further increase in money invested in the capital market and the development of the global capital market. Alongside this came the dematerialisation of securities, which changed their paper form to electronic data (Pavlát et al., 2003, 90–104).

## **2.1 Partial summary**

The origins of trade in securities go back to the 12<sup>th</sup> century, when it was an informal and uncodified activity. With the development of foreign trade and the use of various forms of credit, there appeared the first organised stock exchanges with internal organisation and internal private rules of conduct among the participants. Regulation as known today came in the 19<sup>th</sup> century. The actual development of modern capital markets began in the 20<sup>th</sup> century when, despite the two world wars and the division of the world into the market and centrally planned economies, there was great expansion and globalisation.

## **3 The development of the capital market legislation**

The capital market in its early stage, as stated in the preceding chapter, was in no way regulated. In this respect, it seems a legitimate question to ask how the basic interests of society connected to this sphere were protected if at all, namely interest in the proper functioning of the capital market, the relocation of free financial resources from the spheres of surplus to those of deficit and the trust of investors in the capital market as a whole to which they were all inextricably linked.

The given article shall focus on the analysis of the development of the relevant legislation of the capital market in the USA and Europe. The USA is currently the country with the most developed capital market in the world and is regarded as a financial superpower.

I have chosen Europe as the other research area. For the purpose of the given article, Europe means the European Union, the area of common market founded by the Rome treaty on the European Economic Community that was later transformed into the European Community and finally into the present-day European Union. The legislation of the capital market in Europe was chosen for examination due to the uniqueness of its common and later single market and the current relatively thorough and detailed regulation of the capital market at the national as well as the EU level.

### 3.1 Capital market development in the USA

The development of legislation covering the capital market in the USA clearly indicates that practice was one step ahead of its regulation. In other words, the rules always came only after a negative experience that showed that further regulation was indispensable. All fundamental laws regulating the capital market in the USA at the federal level were passed in response to a systemic and intrinsic problem that revealed the shortcomings of the system and its legislation and demonstrated the need to regulate the given sphere better and more deeply. In the ensuing paragraphs, I thus outline the chronological development of the regulation of the capital market in the USA at the federal level.

The Securities Act of 1933 (sometimes called “*Truth in securities Act*”) was the first federal act regulating trade in securities on the primary market and was passed in response to the great economic crisis of 1929 (Mishkin & Eakins, 2016, 169–170). The act aimed to renew the trust of the public in the capital market and the stabilisation of the market. In order to achieve these objectives, issuers were required to register newly issued securities and to inform their investors. Based on the published information on the traded securities, investors could thus make more circumspect and informed judgements as to whether to buy them. They were also informed of the risks associated with this investment. This information was published in a document reminiscent of today’s securities prospectus. In addition to that, the act criminalised a number of prohibited activities when trading securities (fraud, manipulation of information, etc.).<sup>4</sup>

Unlike the above-mentioned act, the Securities Exchange Act of 1934 did not regulate the primary market with securities on their first issue, but the secondary market. Its significant contribution was the formation of the supervisory authority called the Securities and Exchange Commission (further referred to as the “SEC”) which ensures compliance with the federal laws on securities, namely the Securities Act. The act further defines entities participating in the capital market and offering investment services and stipulates the primary requirements linked to their function, the requirement to register with the SEC among them. Alongside the establishment of the SEC, the act also established self-regulatory organisations in the capital market (further referred to as “SROs”) that, on a voluntary basis, unite individual entities participating in the capital market and create rules of conduct for its members. Typical SROs are specialised stock exchanges, including the NYSE, NASDAQ and CBO.<sup>5</sup>

In 1939 the Trust Indenture Act was passed; this established several definitions and duties of issuers of debt securities in their public distribution and increased the protection of investors.

As financial investment had been developing in the 1920’s, thus enabling small investors to enter the capital market, it was necessary after the great crisis to bring this segment of investors back to the capital market. Hence, after extensive research into the problem by the SEC, the Investment Company Act (further referred to as the “ICA”) was passed in 1940. The act sets minimum requirements for management companies and mitigates the conflict of interest between the management company and investors. At the same time, management companies are required to inform their investors as to their financial situation and investment policy before the purchase of their securities and regularly after their purchase. Information on the management company and the fund managed by it is published in a way that is reminiscent of the present

---

<sup>4</sup> The US Securities and Exchange Commission. *The Laws That Govern the Securities Industry*. Online: <https://bit.ly/3UDc35H>

<sup>5</sup> Cornell Law School. *Securities Exchange Act from 1934*. Online: [https://www.law.cornell.edu/wex/securities\\_exchange\\_act\\_of\\_1934](https://www.law.cornell.edu/wex/securities_exchange_act_of_1934)

day's statutes of collective investment funds. Together with (that is, immediately after) the ICA, the Investment Advisers Act was passed, which set the registration requirements for persons who provide investment advice and recommendations to investors and at the same time obliges brokers to comply with the laws intended to protect the investors.

During the end of the sixties and the beginning of the seventies, another crisis erupted in the USA that was linked to the growth of inflation and a recession in the capital market that had had no precedent in the USA ever since the major economic crisis. The trust of investors in the capital market therefore deteriorated and the reduced amount of capital in the market called for the passage of the Securities Investor Protection Act in 1970. This act had one significant contribution, which was the establishment of the Securities Investor Protection Corporation (further referred to as the "SIPC") which compulsorily united all traders registered with the SEC and required them to contribute to the fund intended to pay damages to investors as the result of the insolvency of traders and breaches of their obligations towards the investors. Currently, any eventual damage to investors is covered by this fund up to 500,000 USD. The SIPC is the precursor of today's securities traders' guarantee fund operating on the territory of the EU member states.<sup>6</sup>

At the turn of the millennium, an enormous scandal, associated with the Enron, Global Crossing and Tyco companies, broke. These companies (and many others that were not covered in the media), on the basis of an artificial overstatement of the financial results, seemed more lucrative to investors, which increased the share price of these companies while their true value was far from their market price (Veselá, 2019, 621–622). On publishing this information, Enron, an energy giant with more than 20.000 employees, crashed and the value of its shares plummeted. As a response to this event, the Sarbanes-Oxley Act was passed in 2002, which significantly increased the liability of corporate management, established strict rules for corporate accounting and reporting to provide supervision and oversight together with setting relatively strict punishments for non-compliance. The act is often called "*the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt*" (Bumiller, 2002). The act established the Public Company Accounting Oversight Board (further referred to as the "PCAOB"), which specifies standards for audits of corporations and supervises their implementation in corporations with shares listed on stock exchanges.

After the mortgage or the so-called speculative crisis of 2008, caused by irresponsible lending and insufficiently collateralised mortgages, led to the global recession that affected the global capital market (Veselá, 2019, 623–629; Bodie et al., 2014, 15–23; Mishkin & Eakins, 2016, 171–178), the Dodd-Frank Wall Street Reform and Consumer Protection Act was passed in response to this negative event in 2010. Its objective was to increase the protection of investors, restrict some commercial practices linked to offering investment services, increase the transparency of companies listed on stock exchanges, and in particular to consolidate and tighten the criteria for ranking these companies. For this purpose, the act established several federal bodies, including the Financial Stability Oversight Council, which monitors the economic and financial stability of major financial corporations, the insolvency of which may have a negative impact on the economy of the USA as a whole (just like the crash of Lehman Brothers bank during the mortgage crisis), and the Consumer Financial Protection Bureau that supervises the loan market and responsible lending not only to consumers and, within the SEC, the act establishes a special commission to monitor rating agencies (Mishkin & Eakins, 2016, 448–450).<sup>7</sup>

---

<sup>6</sup> Online: <https://www.sipc.org>

<sup>7</sup> Online: <https://www.cftc.gov>

Based on the facts listed above, it can be said that the legislation in the sphere of capital market is a kind of ex-post legislation that later responds to unwanted situations in order for them not to happen again. All the passed acts have sought to increase the protection of investors and their awareness of investments offered to them. It is from the first half of the 20<sup>th</sup> century that we can trace standards that were later adopted by European legislation, to be mentioned further in the article, such as information requirements for issuers, banning conflicts of interest in management companies and guarantee funds, and the rules of conduct of brokers.<sup>8</sup>

### 3.2 Development in Europe

The regulation of the capital market on the territory of the European Union does not have such a long history as the USA for good reason, since before the Rome Treaty was signed in 1957 there was no common market that could be regulated jointly. Even after the signature of the Rome Treaty, this common market was still in its infancy; the free movement of capital was quite limited, and its main regulation was in the national legal systems of individual member states. The significant development was caused by the arrival of the internet and the cross-border trade that led to the globalisation of markets in the eighties and then in particular by the signature of the Single European Act in 1986, which created a new European Community (Valiante, 2018, 79–80).

On reforming the common market into the single market and further economic integration of the European Communities, as well as significant intensification and expansion of the four basic freedoms of the single market, the basis for the common currency was formed and the European Union was founded by the Maastricht Treaty on the European Union in 1993, which existed alongside the European Community until its unification and connection by the Treaty of Amsterdam, the Treaty of Nice and finally by the Treaty of Lisbon. The last-mentioned treaty gave the EU international legal personality and a supranational character (Týč, 2010, 19–25).

In the following paragraphs I trace the chronological development of the EU legislation of the relevant sphere of the capital market from the beginning (i.e. the signature of the Treaty of Rome and the foundation of the EEC) until now. Since, during this period, the given sphere was regulated by a plethora of directives and regulations, research into which would go beyond the scope of this article, I focus solely on the regulations that I deem important for the purpose of this paper and ground-breaking in the historic overview.

#### 3.2.1 Freedom of establishment

As mentioned in the introduction to this paper, the basis of the capital market is the capital flow from the spheres of surplus to the spheres of deficit and, as the capital market has an international character as it had in the EEC, it is indispensable for spheres of surplus in individual states to be able to invest capital in other states and for entities with a deficit to seek capital in other states in the Common Market. The first step enabling cross-border capital flows was the harmonisation of rules on the cross-border establishment of entities with a deficit (corporations) on the territory of other member states, where such legal persons could acquire capital by means of share subscription and, if needed, listing them on national stock exchanges. Freedom of establishment was stipulated in the original Treaty on the European Economic Community in arti-

---

<sup>8</sup> More at: Bodie et al. (2014, 83–91).

cles 52–58 and of particular importance was article 54, paragraph 3g, which stipulated that “by co-ordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by the Member States of companies or firms within the meaning of the second paragraph of Article 58 with a view to making such safeguards equivalent throughout the Community.” Building on this provision, the EEC adopted several important directives that harmonised the given sphere and at the same time ensured adequate protection of special entities, namely members and creditors (third parties) of established corporations. Below I give a basic overview of the above-mentioned directives influencing the given sphere.

Directive 68/151/EEC of 9 March 1968 introduced the common standard for the protection of members of an established company and introduced primary standards for unified information that such companies must publish in their financial statements to provide a genuine and complete picture of the state of the company. Compulsory audits of these companies by auditors who were further regulated by the EEC legislation were established alongside it. Even at the onset, we can see the attempts of the EEC legislators to improve the quality of information provided to investors and not only by issuers.

Directive 77/91/EEC of 13 December 1976 further developed the preceding directive and consolidated the principles of protection of members during the establishment and in particular a change in the share capital of a joint-stock company with foreign founders.

The next one was Directive 78/855/EEC of 9 October 1978, which extended the protection of shareholders and creditors in accordance with the preceding directives, not only in the cross-border establishment of corporations, but also in cases of mergers of public limited liability companies. It was soon followed by Directive 78/660/EEC of 25 July 1978, which extended common minimum standards for financial statements for some companies (in particular joint-stock companies), these being the key indicator of the financial and economic situation of a corporation. It is on the basis of this information that investors make judgements about whether the corporation is attractive enough to invest in it and, if this information is not misleading, genuine and complete, the investor can make a qualified judgement on whether or not to invest in the company.

Subsequently, there was a need to harmonise the same conditions for shares of foreign companies being listed on EU stock exchanges in another state, thus Directive 79/279/EEC of 5 March 1979 was adopted, which set minimum standards for securities to be listed on the stock exchange, and shortly followed by Directive 80/390/EEC of 17 March 1980 on the securities prospectus to be listed on a stock exchange. Since then, the prospectus has been another source of information for investors, as it provides them with relevant information about the company and its investment intentions, as well as information as to the risk level of the given investment without having to scrutinise financial or other statements of this corporation.

These directives were followed by the extension of protection of members and creditors of established and listed companies, as well as the adoption of Directive 82/891/EEC of 17 December 1982, which was a response to the insufficient regulation of the above-mentioned Directive 78/855/EEC and also extended the standards of protection of persons to cases of the division of public limited liability companies. Directive 83/349/EEC of 13 June 1983 in its turn established the requirement for groups of enterprises under common management or otherwise related to publish their financial statements on a consolidated basis; in other words, to provide information not only on one company, but on the group as a whole, which extended and improved the awareness of investors and third parties as to the economic and financial situation of all the corporations in a given group.

To harmonise the types and quality of the information provided, as well as the means of their publication and compilation, there came the unification of the same requirements for the

professional competencies of persons who check the information published or directly compile it, namely auditors and accounting advisors. Directive 84/253/EEC of 10 April 1984 introduced the requirement for member states to subject these persons to an approval process, in which member states were obliged to examine their professional competencies for the performance of their activities.

Following the adoption of the latter directive, the area of freedom of establishment for several types of corporations might be deemed relatively harmonised, and investors from individual states of the community might, with a relative degree of qualification, invest in companies established abroad or, if needed, into domestic companies based on the same standards of awareness and protection as in other states. Simultaneously, corporations could be established and could list their securities on individual national stock exchanges under similar conditions as elsewhere in the common market. All of this led to the development of suppliers of investment services, the so-called brokers, connecting investors and issuers.

### 3.2.2 Free movement of services

Free movement of services, including the investment services outlined above, was stipulated in articles 59–66 of the Treaty on European Economic Community and several relevant directives were adopted to harmonise the free movement of investment services. Collective investment was the first area to raise great interest, since collective investment involves a high amount of money from a wide base of investors, the protection of whom is always paramount. For this reason, Directive 85/611/EEC of 20 December 1985 was adopted, which was the first to harmonise investment via collective investment funds. However, it applied solely to funds investing in transferable securities, which, upon the request of investors, repurchased participation certificates from investors for their fair value according to the underlying assets of these participation certificates, the so-called UCITS<sup>9</sup> funds, hence another name of the directive – the UCITS Directive. It set standards for the licensing of such funds, their management companies, and depositaries, established the common standard for the management of the assets of the funds, their structure and investment options; that is, a definite list of assets to be invested into including the share of such investment relative to the total value of the fund. It also set the requirement for publishing information provided to members by funds or their managers. This directive was later slightly amended by Directive 88/220/EEC of 22 March 1988, which responded to the special feature of Denmark's capital market, with a high level of investment in state bonds or other bonds with a high rating, so the directive increased the possible proportion of such bonds in the assets of UCITS funds.

At the very moment when the sphere of collective investment was harmonised, interest was focused on the harmonisation of investment services provided to individuals, thanks to which the relatively important Directive 93/22/EEC of 10 May 1993 was adopted. This aimed to regulate the standards for the protection of individual investors, fair competition between investment companies, the provision of investment services across the borders of individual states and monitoring the solvency of investment companies and the prudence of their business activities. The directive had two main objectives (i) protecting the assets of investors and (ii) ensuring the proper functioning of securities markets. In order to reach these objectives, the directive harmonised the rules of licensing investment companies, national monitoring of enterprises,

---

<sup>9</sup> “Undertakings for the collective investment in transferable securities”.

the requirement to inform investors, and the requirement for member states to monitor investment companies' compliance with the rules of prudent business activities. In this connection, it is necessary to mention that the given directive did not expressly apply to the provision of investment services of collective nature, which were still harmonised by the above-mentioned Directive 85/611/EEC.

Collective and individual investment services were later further harmonised by the game-changing Directive 95/26/EC of 29 June 1995, which responded to the experiences of improper use of relations between investment companies and third parties and in particular disclosure of confidential information on the position and investment of companies and it therefore increased the number of compulsorily shared facts between auditors and supervisory authorities and restricted the possibility of investment managers sharing information that third parties could abuse to the detriment of the enterprises or other investors.

The UCITS Directive was later substantially changed by Directive 2001/107/EC of 21 January 2002, which defined some new investment services that might be provided by some management companies (individual portfolio management for individual investors if still within Directive 93/22/EEC), introduced the requirement to publish both the securities prospectus and the simplified securities prospectus, which significantly improved the awareness of investors as to the substance of the investment strategy of the fund, harmonised new standards for internal business control for the protection of investors and some other requirements and possibilities for management companies and depositaries of funds of collective investments. Immediately afterwards, Directive 2001/108/EC of 21 January 2002, was adopted, which enabled UCITS managers to add new investment instruments in the form of participation certificates of other UCITS or even derivative instruments to their portfolios, regarding which the fund manager must duly inform investors in the prospectus and other documents.

A completely ground-breaking initiative to harmonise the provision of investment services was to become Directive 2004/39/EC of 21 April 2004 on markets in financial instruments (Markets in Financial Instruments Directive), commonly known by the acronym MIFID. It was unprecedented in its scope as well as the quality and details of the harmonisation itself. This was achieved due to the so-called Lamfalussy process (Sergakis, 2018, 5–8) being used in the process of its creation.

The main objectives of MIFID were (i) to respond sufficiently to new technologies when providing investment services, (ii) to increase the protection of investors, and (iii) to improve competition in the single capital market. I deem the adoption of new rules of conduct of investment companies towards investors and the division of investors into three main groups – eligible counterparties (big financial or other institutions), professionals (standard or bigger companies), and retails, as well as the introduction of specific requirements for conduct and provision of services for each individual type of investors to have been essential steps. The directive also introduced the requirement to examine the appropriateness of an investment instrument and service for the given investor before providing a particular service and for the execution of orders from the investor according to their best interest (best execution), in the sense of their fastest, least expensive and most effective fulfilment.

Another important instrument was the unification of organisational requirements for investment companies in the form, *inter alia*, of compliance requirements, obligatory risk management, the audit of companies independent of executive authorities of the company and the system of searching for and managing conflicts of interest between executives. MIFID also introduced plenty of new rules ensuring the transparency of trade, the extension of the requirement to inform in connection with both investors and supervisory authorities and also increased

the number of investment instruments by adding financial and commodity derivatives, and increased the number of investment services by adding investment counselling. Last but not least, it enumerated new methods of trade and trading platforms via which such investment services can be provided (Multilateral Trading Facilities) (Casey & Lannoo, 2009, 33–38). The period for transposition of the directive by the member states was by 30.4.2006 and it continued to apply until its successor, Directive 2014/65/EU of 15 May 2014 so-called MIFID 2, was adopted. The directive is still in force alongside the associated Regulation 600/2014, known as the MIFIR, of 15 May 2014. Both of them further develop the investor protection and stability of the market in particular as a response to the previously-mentioned US mortgage crisis.

In this connection, is it worth mentioning that MIFID harmonised the provision of investment services to individual investors, while collective investments (originally harmonised by Directive 85/611/EEC) were harmonised separately from this segment of investment services. The rules on collective investment were amended no sooner than 2009, when Directive 2009/65/EC of 13 July 2009 was adopted. Following the line of MIFID, it extended investor protection, simplified the cross-border provision of collective investment services and made the given segment more transparent and stable.

By way of recapitulation, it is worth mentioning that, in terms of ensuring the freedom of establishment of corporations in EU as well as the listing of their shares on national stock exchanges, the effort of the EU legislators focused on the regulation of the provision of investment services. These services are indispensable for stimulating the basic functions of the capital market and perfectly matching demand and supply; nevertheless, their inappropriate provision jeopardises the trust of investors in the capital market, which is one of the main pillars on which the proper functioning of the capital market is based.

It was only after the basic harmonisation of collective investment services that the interest of EU legislators focused on individual investment services provided to individual investors, whose assets were managed services independently and individually by the providers of investment. This dualism in the provision of investment services is still visible both at the level of the European Union and the level of the majority of national legislation systems, where collective investment is regulated separately from investment for individual investors.<sup>10</sup>

### 3.2.3 Prudent provision of investment services

Alongside the harmonisation of the provision of investment services as described in the preceding chapter, the EU's interests, were focused on the quality of such services. Good quality investment services have a positive impact on investors trust in the capital market and hence the very functioning and stability of the capital market. It is yet not easy to say what a good quality investment service looks like. The market risk of the investor may be minimised if the service provider thoroughly, fairly and completely informs and examines his or her knowledge and experience in the sphere of investment protect against non-qualified judgements before providing investment services.

The credit risk may be reduced further by ensuring that the investment company provides its services with prudence, by which it should ideally limit the risk of its failure. Prudential rules for the provision of investment services may be defined as a set of rules to ensure the essential

---

<sup>10</sup> F.e. regulation in Czech Republic in Act Nr. 256/2004 Sb., of undertaking on capital markets (individual) and Act Nr. 240/2013 Sb., of investment companies and investment funds (collective).

organisational and eligibility provisions for the functioning of the investment company, its by-laws, the system of internal control, and the basics of monitoring the financial and operational stability of the investment company.<sup>11</sup>

Although the prudential rules are directed at the internal processes inside investment companies, some of them de facto set rules of conduct with regard to investors, so it cannot be said that such rules can be strictly divided from the external rules of conduct of investment companies. These rules are usually adopted gradually and, with the development of investment services, they are gradually extended and improved.

Prudential rules have to a certain degree always been specified in individual directives regulating investment services as described in the preceding chapter; however, the first important directive to focus comprehensively on the adoption of prudential rules for all investment (and loan) companies was Directive 93/6/EEC of 15 March 2009. This followed on from the above-mentioned Directive 93/22/EEC, which, however, only harmonised the fundamental framework of cross-border recognition of companies without prescribing common requirements for the capital of such companies or for controlling the risks to which these companies are exposed. The directive thus divided investment companies into several categories according to the services provided, then specified the minimum amount of share capital for each type of company, later introducing the requirement for companies to have the prescribed amount of free capital to cover the financial risks of the company at all times. It further introduced the requirement to monitor and manage their credit exposure and, on a daily basis, to check and assess the positions in its trading portfolio and also required the supervisory authorities to review companies on a so-called consolidated basis. Compliance with the requirements stipulated by the directive was to be checked by national supervisory authorities which, as the directive stipulated, were to be informed by the companies.

This directive was further amended by Directive 98/31/EC of 22 June 1998, which responded to numerous frauds by investment companies in the capital market during the futures exchange and the abuse in futures exchange as well as for the sake of the trading portfolio include the positions in commodities and commodity derivatives previously not required to be monitored and in some cases reported to the supervision authorities. The directive also introduced stricter methods for assessing companies' trading risks.

Directive 93/6/EEC was later replaced by Directive 2006/49/EC of 14 June 2006 which was a follow-up to MIFID. Although including some framework and marginal prudential rules, MIFID lacked norms for harmonising capital requirements and the system of risk surveillance for investment companies. The main objectives of the new directive were (i) the adoption of minimum requirements for the capital adequacy of investment companies, (ii) setting surveillance rules on the prudent provision of investment services inside the investment company, and (iii) increased cooperation between the supervisory authorities of the member states. This directive quite thoroughly specified and extended the requirements harmonised by previous directives with similar goals.

As a result of the global crisis, which erupted in the USA in 2007 and which has been mentioned in the preceding chapters, a group of financial experts met at European Union level. It was presided by Jacques de Larosière, the former governor of the central bank of France. The objective of this meeting was to find a solution for eliminating the impact of similar global crises on the financial market of the EU. Its outcome was the publication of the so-called Larosière

---

<sup>11</sup> See more at: Husták & Smutný (2016, 173–186).

Report as an attempt to explain what caused the crisis and simultaneously suggest several measures to prevent future crises in the single market. One of its crucial suggestions was the introduction of consistent single unified regulatory rules for the capital market in the EU and the substitution of the so-called harmonisation system of regulation by direct regulation, binding on the member states.<sup>12</sup>

A response to the Larosière Report was the replacement of Directive 2006/49/ with the new Regulation 575/2013 of 26 June 2013, which directly administers the sphere of prudential laws in all the member states and is still in effect. In the new regulatory regime after the report, Regulation 600/2014 was also adopted as a successor to the above-mentioned Directive 2014/65/EC, and stipulated binding prudential requirements for investment companies licensed within MIFID 2.

The development of the legislation shows that these rules have been changed numerous times in their essence, and the sphere they harmonised has been increasingly regulated in order to ensure the most effective functioning of the capital market. A closer study of the EU legislation outlined reveals that all legislation that was either amended or newly adopted among other objectives was intended to improve the functioning and transparency of the capital market and the investor protection, which is the main prerequisite for the allocation of sufficient capital in the market and its duly and healthy functioning.

### 3.3 Comparison

Comparing the development of the legislation of the capital market in the USA and the common and later single market of the EU, we can trace several differences and also some important common points and principles. The fundamental difference in the legislation of the two markets stems from their different systems of government. The capital market in the USA is regulated at the federal level while the EU market was, for a long time, regulated only by harmonising directives while the European Economic Community, later European Community, and finally the European Union tried to bring the relevant regulations of member states closer to each other.

During the long history of the development of the capital market in the USA, it has undergone several noticeable crises and relevant legislation usually came *ex post*, i.e. after a negative experience and as a response to this crisis.

The European capital market as a whole did not experience a noticeable crisis during the whole period of its existence until the USA crisis reached it in 2007, so the adopted legislation was first of a technical character with the objective of propelling cross-border investment and practically “launch” the functioning of the common capital market. The legislation adopted later was rather a response to deficiencies in the functioning of the market in individual cases and had no fundamental EU impact. The change came after the crisis of 2007 and the Larosière Report, which resulted in the EU capital market being regulated directly via directly applied regulations.

What the two legislations have in common is the objective that the legislation set as time passed. As it can be seen in both cases, the original objective was to set basic rules for the functioning of the capital market itself, to enable corporations to have their shares listed on securities stock exchanges, where they could later be offered to investors, and establish the fundamental requirement to inform investors; in other words, to regulate the primary market.

---

<sup>12</sup> See more about Larosière report at: Sergakis (2018, 8–11).

After securing this starting point, the legislation aimed at the secondary market and the suppliers of investment services. The priority in both these spheres was collective investment (the Investment Companies Act in the USA, Directive 85/611/EEC in the EEC) rather than individual investment (the Investment Advisors Act in the USA, directive 93/22/EEC in the EEC).

After the basic regulation of the suppliers of investment services, the legislation attempted to increase investor protection and their trust in the capital market by adopting laws that first regulated the conduct of issuers and brokers with the investors and information provided to them in order to minimise the capital risk to investors and increase their qualification and awareness. This legislation was later accompanied by regulating the prudent supply of investment services, the objective of which was to reduce the credit risk to investors even further.

Both legal systems show that with, the passage of time, there is a growing tendency to improve investor protection. This leads us to conclude that it is the trust of investors in the capital market that is in reality the essential prerequisite for the proper and healthy functioning of the market as a whole.

#### 4 Conclusion

This paper compared how the common objectives and interests in passing laws regulating the capital market were implemented in the USA and in the EU from the creation of the European Economic Community to implement of the MIFID 2 Directive and MIFIR Regulation. By exploring the history of capital markets, I studied individual legislative acts that are important in regulating the given sphere, first in the USA and then in the EU, together with outlining important historical events.

It is evident in both spheres that, despite the differences in circumstances and historical backgrounds, their gradual development showed similar interests and developed in a similar manner as time passed. At the start of the legislative journey, regulating the very establishment of the capital market and its functioning in the form of listing the securities of major corporations on respective securities stock exchanges, i.e. the regulation of the primary market, was a prerequisite. The second step was to regulate the so-called secondary market, where there were third parties alongside issuers and investors, i.e. suppliers of investment services that help the proper functioning of the capital market and in matching the demand for capital with its supply.

At the moment when the basic rules for the supply of such services were established, legislators attempted to improve the functioning of the capital market gradually and to impose stricter requirements on the entities providing investment services in the market. This attempt can above all be explained by their interest in ensuring the maximum protection of investors who invest the surplus of their capital, since investors' trust in the capital market determines its proper and healthy functioning. Although the two studied spheres have experienced different historical events and the mode of regulating the capital market has been different, their main objectives and interests are the same.

#### References

- Allen, F., & Gale, D. (2007). *Understanding financial crises*. Oxford University Press.
- Bodie, Z., Kane, A., & Marcus, A. J. (2014). *Investments* (10<sup>th</sup> global edition). McGraw-Hill Education.
- Bouvier, J. (2022, August 13). *Rothschild family*. Encyclopedia Britannica. Online: <https://www.britannica.com/topic/Rothschild-family>

- Bumiller, E. (2002, July 31). *Corporate Conduct: The President. Bush Signs Bill Aimed at Fraud In Corporations*. The New York Times. Online: <http://bit.ly/3TYFRt8>
- Casey, J-P., & Lannoo, K. (2009). Origins and structure of MiFID. In *The MiFID revolution* (pp. 26–44). Cambridge University Press. <https://doi.org/10.1017/cbo9780511770470.004>
- de Haan, J., Oosterloo, S., & Schoemaker, D. (2012). *Financial Markets and Institutions. A European Perspective* (2 ed.). Cambridge University Press. <https://doi.org/10.1017/cbo9781139198943>
- Hsu, S. (2017). *Financial Crises, 1929 to the Present* (2nd. ed.). Edward Elgar. <https://doi.org/10.4337/9781785365171>
- Husták, Z., & Smutný, A. (2016). *Investiční služby a nástroje po rekodifikaci*. C.H. Beck.
- Liška, V., & Gazda, J. (2004). *Kapitálové trhy a kolektivní investování*. Professional Publishing.
- Mishkin, S. F., & Eakins, G. S. (2016). *Financial Markets and Institutions* (8 ed.). Pearson Education Limited.
- Musílek, P. (2011). *Trhy cenných papírů*. Ekopress.
- Pavlát, V. et al. (2003). *Kapitálové trhy*. Professional Publishing.
- Pearce, R., & Barnes, S. (2006). *Raising venture capital*. John Wiley & Sons Ltd. <https://doi.org/10.1002/9781118673416>
- Rejnuš, O. (2014). *Finanční trhy* (4. aktualizované a rozšířené vydání). Grada Publishing.
- Sergakis, K. (2018). *The Law of Capital Markets in the EU. Disclosure and enforcement*. Red Globe Press.
- Týč, V. (2010). *Základy práva Evropské unie pro ekonomy* (6. vydání.). Leges.
- Valiante, D. (2018). CMU and The Deepening of Financial Integration. In D. Busch, E. Acgouleas, & G. Ferrarini (Eds.), *Capital Markets Union in Europe* (1 ed.) (pp. 2.01 – 2.43) Oxford University Press. <https://doi.org/10.1093/oso/9780198813392.001.0001>
- Veselá, J. (2019). *Investování na kapitálových trzích* (3. Rozšířené a aktualizované vydání). Wolters Kluwer.

## Legal sources

- First Council Directive of 9 March 1968 on coordination of safeguards which, for the protection of interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community (68/151/EEC)
- Second Council Directive of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alternation of their capital, with a view to making such safeguards equivalent (77/91/EEC)
- Third Council Directive of 9 October 1978 based on Article 54 (3) (g) of the Treaty concerning mergers of public limited liability companies (78/855/EEC)
- Fourth Council Directive of 25 July based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies (78/660/EEC)
- Council Directive of 5 March 1979 coordinating the conditions for the admissions of securities to official stock exchange listing (79/279/EEC)
- Council Directive of 17 March 1980 coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing (80/390/EEC)

- Sixth Council Directive of 17 December 1982 based on article 54 (3) (g) of the treaty, concerning the division of public limited liability companies (82/891/EEC)
- Seventh Council Directive of 13 June 1983 based on the article 54 (3) (g) of the Treaty on consolidated accounts (83/349/EEC)
- Eighth Council Directive of 10 April 1984 based on article 54 (3) (g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents (84/253/EEC)
- Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (85/611/EEC)
- Council Directive of 22 March 1988 amending, as regards the investment policies of certain UCITS, Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investments in transferable securities (UCITS) (88/220/EEC)
- Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field
- European Parliament and Council Directive 95/26/EC of 29 June 1995 amending Directives 77/780/EEC and 89/646/EEC in the field of credit institutions, Directives 73/239/EEC and 92/49/EEC in the field of non-life insurance, Directives 79/267/EEC and 92/96/EEC in the field of life assurance, Directive 93/22/EEC in the field of investment firms and Directive 85/611/EEC in the field of undertakings for collective investment in transferable securities (UCITS)
- Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses
- Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS
- Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC
- Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU
- Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012
- Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
- Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions
- Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012