The institutional reforms of the European Financial Supervisory System, an interim report

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This interim report attempts to give a short overview of the most important workstreams in the field of securities regulation within the EU. It further gives a provisional analysis of the future supervisory structure after the adoption by the Council of ministers of the regulation on the future European Securities and Markets Authority (ESMA) and on the European Systemic Risk board (ESRB) which are now being discussed in Parliament. The existing directives are all open for review, the Market Abuse, prospectus and MiFid directives being the first in line. These include work streams like the organisation of the derivative markets, the application of MiFid to dark pools and OTC equity trading. In the field of Credit rating agencies’ supervision, ESMA will be directly in charge. The proposed directive on Alternative Investment Managers is being discussed, while CESR is working on short selling, packaged retail investment products, money market funds definitions, and the like.

Securities regulation, supervisory architecture, ESMA, ESRB, ESFS.

The financial crisis that started in the second half of 2007 and is still continuing today has severely damaged most of our financial institutions. There are many causes to this crisis, among which an overextension of credit due to very low interest rates for a long period of time, the overleveraging of many financial institutions directly or through derivative techniques, consequently the existence of several asset bubbles, in the real estate sector, in commodities and in the equity markets, leading to over-optimism, relaxing of risk management standards, and so on. It was a failure of many wheels in our financial machinery, and the awakening has been very rude indeed. The damage to what is called the “real economy” will hurt even more.

Like after any other deep financial crisis — think about 1929 — the regulatory consequences are numerous and severe. Several parts of the system will become subject to new, stricter regulations, and the overwhelming approach of relying on market mechanisms will be abandoned in several parts of the system. The times of the “invisible hand” are gone at least for some time. The “efficient market theory” has proved to be unreliable in times of strong stress. Both in the US and in Europe, a widespread effort of

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re-regulating the financial business is under way, leading on the one hand to some significant substantive modifications, on the other to a review of the supervisory architecture.

Although the present paper will mainly address the European scene, it should be mentioned that similar work is being undertaken in the US, and in a more limited way, in other parts of the world, especially in Japan and Australia, as well. Indeed the crisis has been international, affecting almost all industrialised countries, although in a differentiated way, many suffering more from the second round effects on the real economy.

1. **Substantive reforms**

In many respects our financial system had developed way ahead of the supporting financial regulation and of the economic systems which it served. Over the period 1960 to 2007, the relative size of the financial sector in the US increased from 4% to 8% of GDP, while the profits rose from 16% in 1973-85 of domestic corporate profits, to 41% before the crisis.¹

Thereby, the system has become global, making it even more difficult to oversee. Contagion has been more widespread than ever seen before. International cooperation among financial supervisors being largely based on voluntary agreements and exchange of information, proved ineffective.

The traditional regulation of equity markets – in Europe mainly on the basis of ISD and later of Mifid – had in part become obsolete in two respects: trading in derivatives has increasingly replaced trading in equities, and trading on regulated markets is being taken over by trading on OTC markets, including dark pools of liquidity and crossing networks, that are subject to different, or often non-comparable regulations. More generally the regulated markets – say the traditional stock exchanges – pretend that they are loosing significant market share, leading to questions about their function in the overall trading environment, their competitive relationship with other trading venues – is this free riding on their primary activity of listing securities? – and the reliability of the overall pricing mechanism. Mifid has undoubtedly contributed to more competition, but at the same time may have decreased transparency in the price formation. However the jury is still out as to the importance of the phenomenon. There is wide agreement that one should require more post-trade transparency, and require a “consolidated tape”, with reporting immediately following the transactions, at least for regular transactions, and with identification of the trading venue. This would contribute to more transparency leading to stronger integration of the different submarkets or trading venues. Some argue that pre-trade transparency should also be extended to these markets, resulting in a system that is substantially similar to a regulated market. These topics will be included in the planned Mifid Review.

¹ Recent remarks by Lord Turner caused an outcry in London stating: “the City had grown “beyond a socially reasonable size”, “I think some of it is socially useless activity,” he said, adding that the financial sector had “swollen beyond its socially useful size” and seemed to make excessively large profits.”
Investor protection is a core objective of most financial directives. It was mainly pursued through disclosure, the prospectus disclosure being the prototype of the disclosure mechanism. The underlying philosophy was that informed investors could make the right decisions, or at least be fully informed that they would be acting on their own risks. However, under the European regime, the disclosure obligation is systematically set aside for bonds issues, as these are not subject to similar disclosure obligations once the issue exceeds 50,000 euro per security. As a consequence, most issues exceed that threshold and can only be addressed to professional, read institutional investors, such as investment funds or insurance companies, who than offer the same securities as part of a larger package to the end investors, leading to an additional layer of intermediation. When prospectuses are issued, especially in the equity sector, they overwhelm the investor with technical information, are difficult to read as a consequence of disclosure by reference, and finally focus more on the issuer’s and intervening banks’ disclaimers than on informing the investor. It is an irony that the prospectus has become more an instrument to protect the issuer, its bankers and advisers, than to protect the investor. One can hope that the ongoing revision of the prospectus directive take these concerns on board.

A different items in the investor protection area are the “Prips”, the Packaged Retail Investment Products. One sees that in the market financial products are being offered to the retail investor that are substantially similar to the traditional instruments for which extensive investor protection rules are applicable (disclosure, MiFid rules on conflicts on interest, on know your customer, on suitability,) but without the same protections. Some argue that the same regime should be applicable to insure a level playing field, although the main differences are flowing from the applicable tax regime. From the point of view of investor protection, one should strive to develop a disclosure regime that offers the same safeguards, not necessarily as complex as the present prospectus regime, and is distributed according to the same conduct of business rules as applicable for securities under MiFid. This should not result in simply rolling out MiFid in other sectors.

In the professional market, new instruments have taken over the function of the traditional ones. The most spectacular developments have taken place in the derivatives markets, the volume of which exceed many time that of the cash markets. Among the

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2 See prospectus directive, art 3(2)(d); see also art 5(2)
most rapidly expanding new instruments are the credit default swaps, or CDSs, being in essence contracts whereby one party promises to pay the other, against remuneration, in case the debtor defaults. The CDS market has become the indicator of the creditworthiness of numerous firms or states, and may over time at least theoretically even take over the function of the credit ratings. However this market was very poorly organised: it was based on bilateral contracts, that needed to be individually processed, leaving considerable amounts of transfers unperfected. The nominal amount of the entire market reached at a certain moment, 50 trillion dollars or more, although the net exposure, after elimination of the reciprocal positions, is significantly less. There was no transparent information nor disclosure about the pricing of CDSs. For reasons of systemic risks, the authorities, especially the central banks have now ordered measures to reduce the risk and increase transparency. Similar initiatives are undertaken in the US and in the EU. These measures consist of having most CDS processed through a Central Counterparty that acts as the buyer of all CDS sold and the seller of the CDS bought, thereby eliminating counterparty risk and setting off the positions on a multilateral basis. This multilateral technique will significantly reduce the nominal amount of the outstanding liabilities on a continuous basis, thereby reducing exposures. Unclearable contracts for lack of standardisation could usefully be compressed by specialised firm, eliminating the risk as well. Here again the Commission has published a policy paper and will come forward with proposals in 2010.

The dismal performance of the credit rating agencies especially in the segment of structured products – CDOs and similar – has urged regulatory intervention, both in Europe, the US, in Japan and in Australia. Ratings have been introduced in several regulatory instruments as criteria for determining risks: this was the case in the Capital requirements directive, implementing Basel II. They also feature as important risk yardsticks in the insurance, pension fund, investment fund and other fields. In the future, credit rating agencies will be subject to some form of supervision, mainly looking at their organisation and governance, their internal processes, the absence of conflicts of interest, and efficient disclosure. In Europe a regulation has been adopted imposing credit rating agencies to register, and become subject to the regulation’s provisions. This also applies to ratings originating from non-EU agencies: however, a special endorsement mechanism has been provided for those agencies the subsidiaries or branches of which are established within the EU, which may use their group originated ratings, provided the EU firm endorses the rating on the basis of the verifiable finding that the rating in the state or origin is subject to regulatory requirements that are “at least as stringent” as those applied on the basis of the regulation. With respect to other non-EU agencies, an equivalence mechanism has been provided. International cooperation will be necessary to avoid separate and different ratings to be issued depending on the local entity in the ratings group that has issued the rating. A future regulation will provide that the supervision of the ratings will be entrusted to the future European Securities and Markets Authority (ESMA).


\[7\] This path had already been outlined in 2004. See: The role of CESR at “Level 3” under the Lamfalussy process-
In the investment fund sector, apart from the continuous modernisation of the basic legislative instrument\(^8\), major tensions have occurred especially in the money market fund field, where liquidity issues were raised. On that occasion, the large diversity of assets in which these funds have invested in the past has lead to requests for more transparency in their portfolios and to call for a classification of the different types of money market funds\(^9\). This will ensure that funds that present themselves as money market funds effectively contain only short term paper equivalent to cash investments.

The hedge funds and private equity funds have also been designated as having contributed to the crisis. Although these funds have relatively well resisted to the crisis, they are considered to have contributed to its deepening, mainly as a consequence of their action in the markets\(^10\). The Commission has proposed a scheme for regulating the so-called Alternative Investment Management activity, covering all collective management\(^11\). The regulation is applicable to the management function, not to the funds as such. Manager would have to register, as a consequence of which a quasi-prudential regime would become applicable. Among the rules to be mentioned are a minimum capital requirement, a restriction on leverage and on management remuneration, further general provisions on risk management, on liquidity management, on asset valuation, on conflicts of interest and other conduct of business provisions. The proposal which is very controversial, is in discussion at the Council.

Short selling has been at the top of the agenda in the fall of 2008: the heavy sell pressure on the banks’ shares have incited regulators to enact provisions curbing short selling. In the absence of coordination beforehand, the outcome was very diverse, and illustrated the difficulty to enact regulation in this field, also in the absence of a clear legal basis at the European level. After the storm, the supervisors have decided to analyse the subject in more detail, and have adopted a cautious policy of requesting reports on “naked” short position at the level of 0,1% for reporting to supervisors and 0,5% for reporting to the markets\(^12\). The subject whether additional measures are needed for insuring timely delivery in the T + 3 settlement period are being analysed, as this subject touches also systemic risks apart from an instrument to normalise short selling activity.

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\(^9\) Common definition of Money Market Funds, CESR, 09-850, 20 October 2009

\(^10\) See IOSCO next footnote


\(^12\) CESR, Consultation paper on a “Paneuropean short selling disclosure regime”, Cesr, 09-581, 8 July 2009; see for the IOSCO position: Regulation of Short Selling, Report of the Technical Committee of IOSCO 19 June 2009
The issues that have been presented above, all belong to what is commonly referred to as the securities field. But there is of course very important work going on in other fields, going from company law, consumer protection, money laundering and other topics that may have an indirect but substantial influence on the way financial activity is being undertaken. However the other most significant changes certainly relate to the banking and insurance field. In the field of banking regulation, there are four workstreams to update the Capital requirements Directive, dealing i.a. with increasing the minimum requirements, obliging banks to keep some risk in securitised assets, or holding them to account for off balance sheet vehicles. More conspicuously, remuneration policies are being tackled. On the longer term, a reform of the deposit guarantee schemes should be tabled. Crucial in any major reform of banking supervision is the development of a credible ex ante scheme for sharing the fiscal consequence of a rescue intervention in the banking field. Understandably, the national treasuries are not very eager to commit themselves to an agreement obliging them to share the burden of banks active in several European states, without being able to control the supervisory process. Equally crucial are the debates about the accounting standards, affecting both listed and unlisted banks. All this to illustrates that major efforts are being made to secure that after the crisis the financial system will be safer and more protective of general financial and hence economic stability.

In the insurance field, the major reform is called Solvency II, aligning to a certain extent insurance supervision to the banking model. But drawing up regulations is the easy part of the task; the stickier one is their implementation, not only in the rulebooks but also in actual practice. There are numerous proposals for implementing regulations of Solvency II.

2. Today’s regulatory and supervisory scheme

All these efforts to put in place this increasingly complicated regulatory system are first and foremost the work of the European institutions, i.e. of the Commission, proposing legislative measures and the Council and Parliament adopting them. Once the directive or regulation is in place the regulatory efforts are not finished: according to the so-called Lamfalussy scheme, implementing measures can be enacted by the Commission in the 

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13 Reference should be made here to the Commission website and to the website of the Committee of European banking Supervisors, www.c-ebs.org/
14 Reference should be made here to the Commission website and to the website of the Committee of European Insurance and Occupational Pensions Supervisors, www.ceiops.org/
16 Review of Directive 94/19/EC on Deposit-Guarantee Schemes (DGS)
17 By way of example, see eg. on IFRS 39, How the IASB has responded to concerns expressed by EU stakeholders on the project to replace IAS 39 Financial Instruments,(www.iasb.org/Financial+crisis/Response+to+the+credit+crisis.htm added 12 Nov 2009)
18 Solvency II directive, 2009/138, OJEC, 21 December 2009 Not yet available
cases provided for in the directive, on the basis of an agreement with the member states organised in one of the three regulatory committees. The Commission ultimately takes the decisions but has promised not to go against the will of a significant majority of member states, in fact leading to the agreement of all or most member states. These so-called Level 2 measures have the same status as the Level 1 directive or regulations, but contain more detailed provisions. In the Lamfalussy report it was proposed that the Level 1 provisions would be limited to high-level principles, to be further worked out in the Level 2 measures, within the framework of existing comitology. The political process has prevented this aspect to materialise, leading unfortunately to many detailed provisions included in the level 1 measures, making them inflexible and sometimes even ill conceived.

The Lamfalussy system also proposed to create a committee, composed of the existing national supervisors, in charge of advising the Commission and organising the cooperation among them. Moreover, the newly created so-called level 3 committees would adopt additional non-binding measures of a detailed and technical nature. There are three of these so-called Level 3 committees, - one for banking, one for insurance and one for markets and securities – constituted of representatives of the national supervisory bodies. In the case of CESR, created already in 2001, the Committee was essentially the adoption of a different activity and status by the pre-existing FESCO, the Forum of the European Securities Commissions. In 2004, two other committees were installed for the two other business lines: the European Committee of Banking Supervisors (CEBS) and the European Committee of Insurance and Occupational Pensions Supervisors (CEIOPS). While CESR is established in Paris, the two other committee are located in London and Frankfurt respectively.

The level 3 committees were originally essentially advisory bodies to the Commission. Much of the level 2 regulations have been based on advice given by level 3 committees. Over time the function of cooperation and convergence between the national supervisory systems has relayed the advisory work that has however remained very substantial. As part of their convergence objective, they developed peer review procedures, allowing verifying to what extent national legislation - implementing whether EU legislation or the proper rules of the Committee - were divergent. The outcome of this work is often appalling and indicates that much further work must be undertaken to achieve a higher degree of convergence and harmonisation, allowing the European capital market to function as one single internal market. Also aimed at supporting convergence is the work

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19 See the Lamfalussy report, Final report of the Committee of Wise men on the Regulation of European Securities Markets, 15 February 2001
21 These are: the European Banking Committee, the European Insurance and Occupational Pensions Committee, and the European Securities committee.
22 Legally, these committees are constituted according to national law, and have been recognised as advisory bodies to the Commission. The Committee have their own governance and charter, however increasingly determined by Commission decision, see e.g. Commission Decision of 23.1.2009 establishing the Committee of European Securities Regulators C(2009) 176 final
relating to the practical interpretation of existing legislative provisions: this takes place whether under the form of recommendations, or of Q&A, whereby the opinion of CESR and its 27 members is published. Third parties are entitled to rely on these interpretations, both in their relationship with the supervisors, and one hopes also in the dealings with other instances, such as the national judiciary.

The aforementioned instruments remain however soft law instruments: national securities supervisors are expected to adhere to these recommendations, interpretations, or other statements but these are not legally binding. If they do not, and apart from a negative mention in the published peer review reports, there are no special sanctions attached. This lack of binding power constitutes one of the important weaknesses in the present system. The new supervisory system is likely to find a more adequate answer to this problem.

If one would draw conclusions about the first 8 years of functioning of CESR, it is undeniable that a very considerable amount of work has been realised, both in advising the European Commission, and in developing proper instruments, and these have allowed the securities markets to function more efficiently and more flexibly. Also due to its large consultation practices CESR has become a respected and frequently addressed reference point for market participants. The close relationship with the national supervisors has guaranteed the common work to remain in line with the views and specific concerns of the national supervisors. This consensus culture was an essential element for creating the basis for the trust among the national supervisors. Recently, with the cooperation maturing, and the increased need to take decisions even with some members disagreeing, the consensus rule has from October 2008 been changed into a Qualified Majority Voting of QMV system, based on the Nice Treaty key. This change has already made possible the adoption by QMV of a number of decisions, although the objective remains that decisions should be taken by consensus23, for the reasons indicated above.

The crisis has however alighted the fires of change: there is considerable need to adapt regulations to the post-crisis realities, and the increased need of faster upgrading and harmonising the regulations have lead the European institutions to undertake a more fundamental change in the regulatory set-up. In October 2008, the President of the European Commission requested a high level report from a working group, chaired by Mr. Jacques de Larosière, former French governor and director-general of the IMF, on the future financial regulation and supervision, and to indicate how the supervisory system should be considerably improved. Indeed, the crisis has revealed that serious weaknesses had showed up in the present system, such as the absence of a strict following-up on systemic risk that has been at the core of the financial crisis, but also the diversity in rulemaking within the Union, that prevents supervision to be effectively exercised. Also, some loopholes have to be filled in: as mentioned above, some parts of the market are too weakly regulated and supervised, leading to the migration of risk to the less supervised areas.

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23 See CESR’s charter, art 6.2 “Decisions by the Committee are taken by consensus, consensus being understood as all members concurring, with one or two exceptions”.
3. The future regulatory scheme

The de Larosière report was published on 27 February 2009\(^\text{24}\). It was supported by the European Council, inviting the Commission to come forward with more detailed proposals\(^\text{25}\). The Report touches on a wide range of issues, both of a substantive nature, or dealing with the external position of the EU, i.a. in the IMF. These will not be commented on here. We will concentrate on two avenues of reform, both touching on the future supervisory architecture, one dealing with macro-prudential supervision, the other with micro-prudential supervision. The first one is known under the name of the future institution that will embody this approach, namely the European Systemic Risk Board (ESRB), the second is referred as the European System of Financial Supervisors (ESFS), under the heading of which the three existing committees will be upgraded to European institutions with their own competences. The following description is based on the Council decision of 21 October for the ESRB and of December 2\(^{nd}\), 2009 for the ESFS. The Parliament will take up its work in 2010, leading expectedly to a common decision in the first half of 2010.

3.1 The European Systemic Risk Board

As mentioned, one of the great weaknesses of our supervisory structure before the crisis was the absence of a clear and systematic analysis of systemic risk factors that might bring down part or even the entire financial system\(^\text{26}\). Already since several years however central banks, in several parts of the world have studied developments that might have a high impact on financial stability and trigger contagion effects. These studies remained on the shelves: they listed a great number of systemic risk factors, but did not indicate which one should have requested the immediate attention of the supervisors. So e.g. was the subprime risk identified in some of these reports, e.g. by the Bank for International Settlements\(^\text{27}\), but this risk ranked less high than the risk created by the highly leveraged hedge funds. Looking backwards, it is interesting to consult these reports and reflect on the weaknesses of our predictive capacity\(^\text{28}\). Moreover there were no clear direct warnings addressed to a specific part of the financial population. The times were not ripe for listening to these cassandras: optimism was all-pervasive, the markets were euphoric: the more markets raised, the more profits were generated to the enjoyment of both managers and investors.

\(^{24}\) de Larosière report
http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf; see also the report by Ieke van den Burg, European Parliament, Committee on Economic and Monetary Affairs, Report with recommendations to the
Commission on Lamfalussy follow-up: future structure of supervision
(2008/2148(INI)) Rapporteur: Ieke van den Burg and Daniel Dăianu, 18 september 2008
0359+0+DOC+WORD+V0//EN&language=EN

\(^{25}\) European Council, Presidency conclusions, pt. 22, 18–19 June 2009

\(^{26}\) The often quoted definition of systemic risk is as follows: “financial system instability, potentially catastrophic, caused or exacerbated by idiosyncratic events or conditions in financial intermediaries”. The often quoted definition of systemic risk is as follows:

\(^{27}\) See BIS, Annual Report 2007, “Piecing the puzzle together” mentioned the problem, was was overall positive; comp. the report for 2008, www.bis.org/publ/arpdf/ar2007e1.pdf.

\(^{28}\) See e.g. the FSA 2007 risk report.
After the shock of the crisis, both in the US and in the EU, it is now proposed to put a special body in charge of tracing systemic risks on the basis of a wide macro-prudential analysis. Based on information collected from the newly constituted European supervisory authorities, the European Systemic Risk Board (ESRB) will be able to get a Europe wide view of developments in the different EU markets and would be able to address warnings and recommendations to the national supervisors. These recommendations would oblige these supervisors to state whether they intend to respond to the recommendations, and if no action is undertaken what are their reasons (“act or explain”)\(^29\). If no action from the concerned national authorities would be forthcoming, although the situation was considered serious, the point will have to be taken up at the political level.

Two points have triggered considerable debates in connection with the ESRB. First its governance structure: the ESRB will be composed of a general board, a steering committee and an advisory technical committee.

The General Board will be composed of the ECB, represented by its president or by its vice president, the governors of the 27 central banks,\(^30\) a member of the European Commission, the chairpersons of the three supervisory committees. Among the non-voting members will be the chair of the Economic Financial Committee and one representative of the national supervisory authorities, on a rotating basis, depending on the subject to be dealt with. Decisions will be taken by simple majority\(^31\) except for formal recommendations – but not for warnings - and for the decision to publish a recommendation.

The ESRB chair will be elected by the board among its members central bankers: it may be the president of the ECB, but not necessarily. The vice-chair may be elected from among all voting members, hence it may also be a chair of a supervisory authority.

The steering committee is likely to be very important for the day-to-day functioning of the ESRB. It will prepare the meetings of the General Board and monitoring progress of ongoing work. It will be composed of the chair and vice chair of the ESRB and 5 central bankers, members of the general board, three from the Euro area, two from the non Euro area, a member of the Commission, the chairs of the three supervisory committees, and the president of the EFC.

The Advisory Technical Committee is the extended version of the Banking Supervisory Committee, an advisory committee within the ECB. It will with the support of the ESRB secretariat provide support to the ESRB.

With respect to collecting information, the ESRB will be able to collect information from different sources such as the European System of Central Banks, the Commission and the national statistical offices. However the main source of information is likely to be the European System of Financial Supervisors, in fact the three newly constituted

\(^{29}\) Art 17, Proposed regulation, on the basis of art 95

\(^{30}\) Art 1, proposed Council Decisions, Com(2009)500 final on the basis of art 105(6) of the treaty

\(^{31}\) but with a 2/3rds quorum.
authorities. Only if the authorities do not have the data can the ESRB address itself to an individual member state. As a rule the authorities will transmit information in a collective or summary form, without identification of data about individual institutions. The ESRB can obtain individual data but only to the extent that the authority has been convinced about the “justified and proportionate” nature of the request. This complex system has been agreed to clearly define the different responsibilities of the ESRB and of the supervisory authorities.

3.2 The European System of Financial Supervisors.

1° Policy issues

The creation of the new authorities goes back to the de Larosière report that outlined the main policy issues in its chapter of Supervisory repair\(^32\). The creation of the authorities, although initially with relatively limited powers, is a crucial step in the organisation of a European system of financial supervision.

“Central regulation, Local supervision”: the de Larosière report made it clear that taking into account the diversity of the European financial markets, day-to-day supervision should essentially remain in the competence of the national supervisors. This approach has clearly been followed in the proposal.

The report also proposed to build on the existing committees that had proved to be effective tools for attaining convergence and supporting European rulemaking, be it of a voluntary basis. The committees, now converted into authorities, will continue to be the expression of the will of their constituent members, the national supervisors, although one can expect over time that the influence of the members will focus increasingly on policy issues, and less on detailed technical agreements.

The independence of the Committees is considered crucial by their members. In their opinion, the authorities are not mere agencies of the Commission, but the expression of their will to cooperate. Therefore the intervention of the Commission is relatively limited. However account has to be taken of the fact to the EU law does not allow for delegation of rulemaking power, to the extent that it would consist of delegation of discretionary or policy decisions. Therefore the authorities’ rulemaking is subject to the Commission’s endorsement, as will be explained later. The approach is comparable to the one applicable to the accounting standards.

The report finally sets out a timetable for implementing its recommendations, and this over a period of three years up to 2012. The Commission was invited to present a detailed plan for the end of 2009, what it did by September 23, 2009. But by and large the Council has adopted the overall Commission proposal on the 2\(^{nd}\) of December 2009. It is expected that the Regulation will be adopted in the first half of 2010, and that the authorities will take up their work in the beginning of 2011.

\(^{32}\) One should recall that the Lamfalussy report, nt.19, already warned:” “…, if the full review were to confirm in 2004 (or earlier as the case may be) that the approach did not have any prospect of success, it might be appropriate to consider a Treaty change, including the creation of a single EU regulatory authority for financial services generally in the Community”, p. 41.
2° Analysis of the new regime.

The proposed text proposes a largely identical structure, mandate and governance for the three committees. The discussion has however mainly dealt with the EBA, and has paid less attention to the specific issues of securities markets regulation.

1° Legal Basis and legal status

It appears that the authorities are not mere agencies, as they have a larger autonomy in terms of governance and have some independent powers. Moreover they are not fully financed by the EU budget. Also the role of the Commission is more reduced.

The question was raised whether it would not be preferable to create one single authority, in charge of the three sectors of financial supervision, and therefore to merge CESR, CEBS and CEIOPS\(^{33}\). Although there would undoubtedly be economies of scale, this proposal has not been followed up, on the one hand as this would create additional issues of coordination of the three different mandates - see infra under “Joint Committee” -, on the other to avoid - until further notice at least - the difficult political discussions about the structure, governance and location of a single integrated body. Furthermore, a merger of the committees would have to deal with important differences in composition, as only in the banking authority, the central banks are represented. Therefore it was rightly decided to tackle first the most important issues, which is the reform of the regulatory architecture. One should add that over time this question may be raised again but in different terms: indeed, one sees a tendency in several states to merge banking and insurance supervision, also under the influence of Solvency II leading to a “twin peaks” system of supervision\(^{34}\). One cannot exclude that taking into account political developments in that direction – already decided in France, in Belgium, and subject to further clarification in Germany and possibly in the UK as well – a reorganisation of the EU wide form of supervisory cooperation along the lines of a “twin peaks” model will be considered.

2° Tasks and powers of the new authorities

The proposed regulation describes the task of the new authorities in terms of coordination and convergence. The proposal does not delineate the powers of the new authorities v.à.v. the existing national authorities: it essentially described the powers of the new bodies, without touching the supervisory powers of the national supervisors. Unless a European regulation decides otherwise – except with respect to the supervision of the credit rating agencies, where CESR will be the sole European supervisor – all supervisory matters remain national, and should be coordinated according to the existing mechanisms, especially within the supervisory colleges. Decisions adopted by the authority are

\(^{33}\) See the position of the European Parliament, Committee on Economic and Monetary Affairs, Press release, 25 November 2009.

addressed to the national supervisors, not to the firms or parties subject to national supervision, unless the regulation disposes otherwise (see infra comment sub article 9).

The significant innovation introduced by the proposed regulation consists in allowing for binding rules and decisions to be adopted by the authorities. However, it is not very clear what is understood by “binding”: as it implies some enforcement instruments, does it mean that the authority could act against a national supervisor, and so yes, before which jurisdiction. This point deserves to be further clarified in the future regulation.

4° The tools of the authorities

The regulation contains three types of tools: first the existing instruments for coordination and convergence, secondly, some optional tools that serve to support cooperation with a view of coordination and convergence, and thirdly the new binding powers.

1° The existing soft law instruments

According to the Regulation these instruments aim “at establishing consistent, efficient and effective supervisory practices within ESFS". These already practised instruments will be maintained and may take different forms:

- Guidelines
- Recommendations and standards
- Supervisory briefings
- Questions and answers
- Reports to the European institutions on their request or voluntarily.

These documents will be adopted by qualified majority vote. They are binding in the sense that members are expected to follow the guidelines or recommendations but then only on a “comply and explain” basis.

2° The supporting tools

A certain number of other tools deserve mention, as they may become quite important in the future supervisory practice without leading to mandatory decisions.

a- the general coordination function of the authorities (art16)

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35 One should not understand this reference to ESFS as limiting the sole powers of the authorities to common subjects. Each authority can continue to adopt its own recommendations and guidelines, if needed coordinated with the two other authorities.

36 art 29 of the Proposed Esma Regulation
As is already the case today, the authorities will continue to act as coordinating body for the national supervisors. This would include exchange of information, making information available to all supervisors, act as a mediator – maybe also on its own initiative, but than probably without the binding character mentioned further – and notify emergency situations to the ESRB.

b- coordination within the colleges of supervisors (art 12)

In matters of cross border supervision, where both home and host supervisors have to act together, much reliance is placed on the colleges of supervisors. The authority will attend the meetings of the colleges as an observer, and stand on an equal footing as far as information is concerned. It will ensure the coherent application of the rules on colleges, and centralise the information collected from national supervisors. Common guidelines applicable to all colleges could be developed.

Up to now colleges are of less importance in the field of securities supervision, where for most matters, the home state supervisor has exclusive competence, and the passport prevents the host state to intervene.

c- delegation of responsibilities (art 13)

The delegation of supervisory responsibilities already forms part of the supervisory system for certain specific matters. Moreover delegation is allowed in national supervisory provisions, and could therefore become operational on a bilateral basis. Delegation also is considered to be especially useful in the functioning of the colleges. The regulation allows to develop the stepping stones for a more elaborate delegation system.

d- Assessment of market developments. (art 17)

Already today the L3 committees regularly inform the European institutions about significant market developments, especially the adverse ones. This function will have to be integrated and expanded significantly to allow the authorities to assume their tasks within the ESRB.

e- Peer reviews (art 15)

The committees have engaged in a programme of “peer review” whereby they assess the degree of implementation of Community rules, including the “technical standards” mentioned in art 7. The proper recommendations or guidelines are also the subject of said peer reviews. These are published and may give raise to further action in the dialogue between the authority and some of its members.

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38 3 L 3 Delegation task force: Delegation of responsibilities, April 2009, CESR/09-19
f- Common supervisory culture (art 14)

The creation of a common supervisory culture has already today been formulated as one of the significant instruments for supervisory convergence. So e.g. do the committees develop high quality supervisory standards, do they promote exchange of information, and in some cases give an opinion to their members if requested to do so.

Already operational today are the programmes for common training, whether with the two other committees, or for the securities supervisors only.

The regulation also mentions exchange of staff whether with the authority or among members. Secondment to the authority is a necessary supplement to the hired staff, as seconded staff will contribute to the expertise and insure an adequate liaison with the national supervisor from which they originate.

g- International relations (art 18)

The role of the Committees in their relations with foreign counterparts is not clearly defined. In the future this role would be better defined and the authorities would have the possibility to enter into agreements, such as Memoranda of Understanding, with non-EU regulators.

Paragraph 3° The legally binding instruments of the new authorities.

The main difference between the pre-existing Level 3 committees and the new authorities lies in their power to adopt binding decisions and this in four cases. This matter is one of the most crucial aspects of the new regulation and as they are likely to impinge on the powers of the national regulators and supervisors, have raised intense political debate. The original proposal of the Commission has been scaled down on a certain number of aspects, without reducing the authorities to paper tigers.

The latter will be precisely defined in two initial directives, amending the existing directives and will then later on be extended in future directives or regulations.

a- binding technical standards (art 7)

The authorities will develop technical standards in the fields specifically set out in the modifying directive. These standards can only be adopted in those fields in which the level 1 – or level 2 – instruments will expressly allow for additional level 3 rulemaking or action. In that sense these will be delegated rules, not original ones, and should be

39 These were not yet published at the moment of writing.
restricted to technical matters. According to the old ECJ Meroni case, there should be no delegation of discretionary matters. There is no involvement of a regulatory committee as is the case for the Level 2 measures, although the standards will necessarily be developed within ESMA and hence reflect the will of the member states’ supervisors.

The technique is not very different from the one followed for the International Accounting Standards, although in the latter case the proposals have been made by a private body. In the field of financial regulation, the Commission has reserved its right not only to refuse endorsement, but also to modify a proposed regulation substituting its own text, or to adopt only part of it. This latter approach has been severely criticised by the three Committees, as putting in danger their independence in the field of rulemaking, what also directly affects their national responsibilities. It also is likely to undermine the strongly needed authority of the new bodies.

The so endorsed standards will have the status of a Community Regulation, with all its characteristics as a directly applicable rule, binding not only on the national supervisors, but also on the firms active in their respective jurisdictions. Enforcement will take place according to the general rules applicable to regulations. With respect to enforcement against national supervisors and in the absence of a specific provision, this can only be undertaken by the Commission, acting against a member state on the basis of art 226 (now 258), or more exceptionally on the basis of article 9, about which more infra. Enforcement against an individual firm should be the work of the national supervisor, or of other market participants. As will be explained in the next paragraph in certain cases, enforcement could also intervene on the basis of art 9, dealing with “Breach of European Union Law”.

b- breach of European Union Law (art.9)

According to this provision, a procedure is introduced allowing, under certain circumstances, the Authority to take action against national supervisors that would have failed to apply the community rules for which the Authority has competence, as referred to in article 1(2).

Whether as a result of its own analysis, e.g. as part of a peer review, or on the initiative from one of the national supervisors or of the Commission, the authority will investigate whether the Securities directives\textsuperscript{41} have been adequately applied by one of the national supervisors and can request from that supervisor all necessary information. At end of this process it may address a ”recommendation” indicating what action should be taken to comply with EU law. If the failing supervisor has not acted within the set time period, the Commission may take a decision, or “formal opinion”, requiring that national supervisor to take necessary action. In most cases it can be expected that this supervisor will follow the opinion of the Authority. However, if no result has been achieved, the Authority may adopt an individual decision addressed to a financial institution and requiring it to comply. That decision will have to be in line with the Commission decision. This quite radical intervention in the sphere of action of the national supervisors.

\textsuperscript{41} These are the directives mentioned in art 1 (2) of the proposed regulation.
supervisors is conditional on the action being based on a directly applicable European provision, being a Regulation, or a technical standard, in the sense of article 7.

c- actions in emergency situations (art.10)

The concerns about financial stability that have already lead to the installation of the ESRB, have further been developed by mandating the authority to take coordinating action of the national supervisors. It will be fully informed about developments and will attend, as observer all meetings of national supervisors. The latter activity will come in addition to the attendance of the colleges of supervisors.

When effective emergency action has to be undertaken, this can take place on the initiative of the authority, coordinating the action of national supervisors. It may also have been addressed in a recommendation of the ESRB. But the Regulation also provides that the Council of ministers can declare an emergency “for the purposes of this regulation”. The procedure for declaring an emergency is quite elaborate: the council will act on the basis of a request from whether the Commission, the ESRB or the authority, meaning also that it can not act on its own initiative. The decision itself with be taken after consultation with the same bodies.

As to the emergency decisions themselves, these would consist of individual decisions addressed to national supervisors, requiring them to take action as called for in the legislation referred to in art. 1(2). As the formulation now stands it would mean that emergency action would be limited to requesting strict implementation of the legislation referred to in art 1(2). Unless that legislation provided for wider powers, one can wonder whether the present formulation would allow taking strong action in case of a further financial crisis.

d) Mediation (art 11)

Straight from the recommendations of the de Larosière report, it was put forward that the new authorities should have the power to mediate in case of conflicting views between the national supervisors, especially in a cross border context. The European Council had endorsed this call for coordinated decision making, leading to a final decision, stating that in case of continuous disagreement, the case should be “settled”

The mediation procedure can only be applied in case of disagreement between national supervisors in a cross border context and relating to subjects specified in the art. 1(2) directives.

The process is a rather classical one. The authority will first intervene by trying to conciliate and find an agreement between the divergent supervisors. If no such agreement has been found, a specific panel will be constituted composed of the chairperson, and two members designated by the board of Supervisors and who are totally independent with regard to the disagreement. This panel will, after having heard the parties and respecting due process, propose a decision to the board of Supervisors,

42 sic in the Ecofin proposal
43 See for the voluntary mediation: Protocol on Mediation mechanism of CESR, CESR/06-286b, August 2006
which then will decide by simple majority. This point is politically important as it confers a considerable power to the authority, and to the mediation panel. It also illustrated that the process is mediation, not arbitration: it is not limited to the mere application of the law, but extends to a wider range of motivations, i.a. based on policy motives.

However, when the disagreement relates to decisions of the consolidating supervisor, a more complex voting system applied: a simple majority will still take the decision\textsuperscript{44}, unless opposed by a blocking minority, according to the QMV rules. It will avoid the consolidating or lead supervisor to be easily minorised by the other members of the college that are confronted with a local risk\textsuperscript{45}. This provision applies notwithstanding the specific rules on fiscal safeguards, to be developed further under article 23. The final decision will be binding on the national supervisors concerned, who are expected to act according to the decision and set aside their own contrary decisions.

e- fiscal safeguards (art 23)

Some of the Member states had a definite fear of decisions being taken by the authorities that would affect their fiscal responsibilities. According to the present formulation, the fiscal safeguard provision introduces the power of an individual Member state to object against a proposed decision, leading to a suspension of that decision, and finally to a referral to the Council of ministers. The Council will have to confirm, in the absence of which the decision will lapse. This means that the burden of proof is on the authority, whereby the latter will have to convince the 27 ministers that the interference of the authority in the business of one of their colleagues is justified. All this illustrates that the authorities will have to be very careful in deciding on cases with potential fiscal consequences, and that their argumentation will have to be rock solid.

The safeguard procedure can only be applied for fiscal motives, not for other considerations of national interest. Moreover it is limited to the two cases that create the strongest risk for national interest i.e. emergency measures (art. 10) and mediation decisions (art. 11).

4° The governance of the authorities.

The governance structure of the three authorities is quite classical: there is a members’ committee, called Board of Supervisors, what some will feel a little confusing with a “supervisory board”. There is a board of elected persons, called Management Board, and there are the chairman and the CEO, in the future called “executive director”.

\textsuperscript{44} This is each member has one vote.
\textsuperscript{45} This could happen for the banking sector in the cases provided in art 129(2) of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) OJEC, L 177, 30/06/2006, and the proposed extension of the decision making power of the consolidating supervisor to Pillar 2 capital requirements and to the reporting requirements (eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52008PC0602:EN:NOT), or for the insurance supervisors according see art 237(5) Solvency II directive, for the case in which the group supervisor will decide in the absence of agreement among the subsidiary supervisors; see also art 238 e.s.
Independence of the authority has been considered crucial in the functioning of the authorities as coordinators of the action of the national, independent supervisors.

The regulation declares that all organs of the authority will act independently and objectively in the Community interest, without instructions from the member states or from the Community institutions. These authorities have been conceived as independent bodies, accountable to the Community institution, but not to any specific institution or interest. In that sense too, the authorities are one more step away from the traditional agencies.

Accountability has been referred to in the provision whereby the annual report has to be transmitted to the three European institutions, the Court of Auditors, the European Economic and Social Committee and the Committee of the Regions, and furthermore will be made public. The work programme will also be transmitted to the European institutions, as is already the practice today.

a- The Board of supervisors (art 25)

This organ comes very close to the existing committee, as its composition is almost identical, being the representatives of the 27 national supervisors, a representative of the EEA states and of the Commission. Only the representatives of the national supervisors are entitled to vote. The EEA states can be admitted as observers. New is the presence, as observers, of representatives of the ECB, of the ESRB and of the two other authorities, EBA and EIOPA.

According to the proposal of the Commission, the votes will be taken with simple majority of the members. For certain matters a qualified majority is required; this is the case of “technical standards” and for the voluntary measures mentioned in article 8, and for the budgetary matters, while the special rule for mediation decisions has been mentioned above. The qualified majority if the one referred to in the Treaty.

The tasks of the Board of Supervisors have been described in very general terms: it includes all matters referred to above, including the election of the chairman, the approval of the work programme, the budget and the annual report.

b- The Management Board (art. 30)

Already today, CEBS and CEIOPS have a Bureau, similar to the management board. The board, which will count seven members, will be composed of the chairperson, six elected members elected by the Board of Supervisors “on a balanced and proportionate basis and reflecting the Union as a whole”. They will decide by simple

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46 See art. 34 for the Board of supervisors. There are similar requirements for the other bodies.
47 art 25(7) of the proposed regulation
48 One may wonder why the voluntary measures referred to in art 8 are subject to QMV.
49 Under the Lisbon Treaty, art.238 (3), until 2014, the former system of weighing votes continues to apply. After that date a double majority will be requested based on 55% of the members states (i.e. 15 out of 27) and 65% of the population of the EU. A blocking minority must include at least four member states. However between 2014 en 21017, a member state may request the present key to continue to be applied.
majority, acting in an independent way. The Commission is an observer, but is voting on budgetary matters.

The competences of the management board are rather straightforward and refer to some essential administrative duties, such as preparing the budget, prepare the annual report and the work programme, draw up staff policy, and exercise disciplinary authority over the executive director, designate members of the appeals board and so on.

c- The chairperson (art.33)

Differently from the present situation, the chairperson will be a full-time independent professional, elected by the members on the basis of “merit, skills, knowledge of financial institutions and markets, and experience relevant to financial supervision and regulation”. It should not be a person active in one of the national supervisors, as he will be designated following an open procedure. The chairperson is appointed by the Board of Supervisors, on the basis of an ex ante confirmation by the European parliament.

The task of the chairperson will be to represent the authority, to prepare the work of the Board of supervisors and of the management board, and chair their meetings.

d- The executive director (art. 36)

The executive director will also be a full-time independent professional. He will be appointed by the board of supervisors.

His tasks have been described as those of managing the authority: ensure the functioning of the authority, propose a draft work programme, and being responsible for the implementation of the approved work programme, prepare the annual budget and the annual report, and manage staff matters.

The executive director is not part of the Management board but will usually be invited to its meetings.

3. 3 The European System of Financial Supervisors (art. 39)

Although the proposed regulation contains a chapter on the ESFS, stating that it is a network of supervisors, the content of the system is rather minimal. The network is composed of the three authorities, and their constituent members. They work together in the Joint Committee of European Supervisory Authorities, in fact the successor to the 3 L 3, composed of the three committees. The cooperation is embodied in the Joint Committee. It would also take place in the Board of Appeal.

a- The Joint Committee of the European Supervisory Authorities (art.40)

This committee is composed of the chairs and executive directors of the three committees, the Commission and the ESRB attend as observers. The role of this committee is to ensure close cooperation among the three authorities, ensure cross-sectoral consistency of work and develop common policies.

Special provisions address the case of the committee in charge of financial conglomerates.
b- The Board of Appeal (art 44)

This Board is called upon to review the decision of the authorities and to make a final adjudication. Its role is considered important for reviewing individual decisions and this before the matter is taken up at the European Court.

The Board of Appeal would be common to the three authorities, being composed of two members for each of the authorities, without being members of the authorities’ organs. One of them will be elected chair. Appeals may be lodged by any natural or legal person, including national supervisors, provided the decision is addressed to that person, directly or indirectly. Rulemaking decisions would be excluded, but mediation awards, or decisions in case of breach of European rules would be viewed. National supervisors may also appeal, but it would seem only if the position of an individual or legal person is concerned.

The board can suspend the decisions that are brought before it. The board may confirm the decision or remit the case to the authority, in which case its holding will be binding. The authority shall be bound by the decision of the Board of Appeal and shall adopt an amended decision regarding the case concerned.

The powers of the Board are quite considerable and are likely to undermine the powers of the board of supervisors. One can question whether this board should be maintained, at least as a decision making body. It could play a useful role in advisory capacity, intervening in the decision making process of the Board of Supervisors, when decision affect the regulations of the other two authorities.

Some early conclusions

The financial crisis has triggered some important initiatives in the field of financial regulation in the European Union. In order to make the system more resilient and more reliable, several new legislative documents have been approved or are planned to be adopted in the near future. At the same time, the regulatory architecture has been significantly modified, paving the way for more centralised, detailed rulemaking and over time also for more European supervision in specific fields. In the institutional field, the basis has been led for stricter implementation of the Community provisions and hence for more integration and more efficiency in the financial markets. A parallel work stream addresses systemic risk with a centralised surveillance and monitoring system. With these reforms Europe is braced for a stronger regulatory system.