



House of Commons
Treasury Committee

Proposals for European financial supervision: further report

First Report of Session 2009–10

*Report, together with formal minutes and
written evidence*

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The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue & Customs and associated public bodies.

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A list of Reports of the Committee in the current Parliament is at the back of this volume.

Committee staff

The current staff of the Committee are Eve Samson (Clerk), Andrew Griffiths (Second Clerk and Clerk of the Sub-Committee), Adam Wales, Jay Sheth, Helen Jackson and Aliya Saied (Committee Specialists), Phil Jones (Senior Committee Assistant), Caroline McElwee (Committee Assistant), Gabrielle Henderson (Committee Support Assistant) and Laura Humble (Media Officer).

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1 Matters arising from further evidence

1. Last session we conducted an urgent inquiry into proposals for European financial supervision and regulation, which are to be discussed at the Ecofin meeting on 2 December this year. These proposals would establish a European Systemic Risk Board, and a supervisory system based on three European Supervisory Agencies. The European Scrutiny Committee asked us for a formal Opinion on these proposals, and subsequently recommended that they be debated on the Floor of the House.¹ Because of the urgency of the situation, we agreed our Report on 11 November. Since then, we have received several further pieces of evidence, all of high quality, from the City of London Corporation, JWG, a financial services think tank, Jane Welch of the British Institute of International and Comparative Law, the Hedge Funds Standards Board, the City of London Law Society, Marica Frangakis and John Grahl, the Association for Financial Markets in Europe, GC100, the Quoted Companies Alliance and NYSE Euronext. The Leader of the House has announced that the debate on the European Union proposals will be held on 1 December. We wish to draw this evidence to the attention of the House for use in that debate. By the time of the debate we will also have taken evidence from the Bank of England and the FSA and the uncorrected transcripts of these sessions should be available.

2. The evidence confirms our earlier view that the timetable proposed for agreeing these proposals is too hasty. We draw attention to a number of new points raised in the evidence, which we did not have time to explore in our earlier report, but all the submissions make valuable contributions. We believe the following points deserve fuller consideration:

- the matters which a single rulebook for various aspects of financial supervision should cover, given the differences in the economies of European Union Member States;²
- macroeconomic differences between Member States, within the eurozone and outside it;³
- the interplay between the technical standards which are to be drawn up by the new supervisory bodies and national supervisory judgements,⁴ and even wider policy aims,⁵
- the difficulties of securing high quality data, and ensuring its confidentiality;⁶
- the extent to which it is appropriate to extend European regulation of securities markets;⁷

1 European Scrutiny Committee, Thirtieth Report of Session 2008-09, *Documents considered by the Committee on 21 October 2009*, HC 19-xviii; European Scrutiny Committee, Thirty-Second Report of Session 2008-09, *Documents considered by the Committee on 4 November 2009*, HC 19-xxx

2 City of London Corporation, Hedge Funds Standard Board, Association for Financial Markets in Europe, GC100, Quoted Companies Alliance

3 Marica Frangakis and John Grahl

4 Hedge Funds Standard Board, City of London Law Society, Association for Financial Markets in Europe

5 Marica Frangakis and John Grahl, Quoted Companies Alliance

6 JWG, Jane Welch, Association for Financial Markets in Europe

- the Commission’s October proposal for “EU central counterparty clearing houses” to be authorised and supervised direct by the European Securities and Markets Authority (“ESMA”), rather than by the relevant national authorities”;⁸
- further areas of legal uncertainty in the way the proposals are drafted.⁹

3. The memoranda dealing with regulation of securities raise several matters of principle. We mentioned the extension of European regulation to takeovers in our previous Report. This is raised in several of the new memoranda, but there are also wider concerns at the proposals for European regulation of securities markets. The City of London Law Society claims regulation of securities is being brought forward without any attempt to “articulate a proper justification of the imposition of a new layer of regulatory responsibility for these areas”.¹⁰ It considers that “the approach up to now in relation to securities regulation has been to allow national authorities to operate their national rules that implement the Community legislation, an approach which reflects the continuing diversity of financial markets each operate under different structural conditions.”¹¹ Concerns about regulation of securities are also raised by GC100, the group for general counsel and company secretaries in the FTSE100, and by Quoted Companies Alliance, a membership organisation working for small and mid cap quoted companies, which warned “we need to remain careful to ensure that the needs of small and medium-sized businesses are not simply submerged in the need to regulate large and complex multinational financial services businesses.”

4. We have not had the opportunity to come to a view on the concerns raised in these further memoranda, but they reinforce our opinion that the process is unduly rushed. As the Quoted Companies Alliance put it “the political process is moving rather faster than the legislative machinery can catch up.”¹² The detail of legislation matters, and although it is inherent in the European system that much of that detail will be elaborated in other forums than the Council of Ministers, the Council needs to have confidence that the legislative framework it agrees is correct, and will not have unintended consequences. We reiterate our earlier opinion that the Minister should not hesitate to use the veto on 2 December if it is necessary, not just to protect the UK’s fiscal position, but to ensure that more time is available to deal with these important issues.

7 City of London Law Society, GC 100

8 NYSE Euronext

9 Jane Welch, City of London Law Society

10 Ev 8

11 Ev 10

12 Ev 33

Formal Minutes

Tuesday 24 November 2009

Members present:

John McFall, in the Chair

Nick Ainger	Mr Andrew Love
Mr Graham Brady	Mr James Plaskitt
Jim Cousins	John Thurso
Mr Michael Fallon	Mr Andrew Tyrie
Sally Keeble	Sir Peter Viggers

European Proposals for financial supervision: further report

Draft Report (*European Proposals for financial supervision: further report*), proposed by the Chairman, brought up and read.

Ordered, that the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 4 read and agreed to.

Resolved, That the Report be the First Report from the Committee to the House.

Written evidence was ordered to be reported to the House for printing with the Report.

[Adjourned till Wednesday 25 November at 2.15 pm.]

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6	Marica Frangakis, Nicos Poulantzas Institute and John Grahl, Middlesex University Business School	Ev 15
7	Association for Financial Markets in Europe	Ev 23
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9	Quoted Companies Alliance	Ev 28
10	NYSE Euronext	Ev 33

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Written evidence

Written evidence submitted by the City of London Corporation

1. The City supports the broad objectives set out by the Commission: a more efficient framework for financial supervision, enhanced financial stability, greater safeguards of the interests of consumers and investors, increased competitiveness of EU financial markets and more integration of EU financial markets.

2. In creating the new structures, it is essential that policy makers remain focused on the outcomes, such as better and more consistent supervision. Key objectives must be to support open markets, to increase competition by encouraging a level playing field and to ensure as far as possible consistency of arrangements globally, regionally and locally, recognising that so many EU firms and markets, as well as their users, have a global presence.

3. It is essential to be clear on the distinction between supervision and regulation. Regulation—the act of agreeing and setting new rules, together with amending existing regulation—should focus on delivering convergence towards a consistent single rule book. Supervision on the other hand, which involves the oversight of individual firms, must allow for a (high) degree of professional judgement to understand the circumstances of specific firms.

MACRO PRUDENTIAL

4. There is a clear case for the creation of a European Systemic Risk Board (ESRB) to ensure dangers to the stability of the financial system as a whole are caught early and clear warnings are given. Of course, as the present crisis has demonstrated, monitoring the risks at the EU level is not enough. There has to be more coordination and interaction with global entities and close bilateral relations with new bodies (eg the new systemic risk body in the US). The ESRB's relationship with these entities needs to be clearly defined and articulated, in the spirit of cooperation and coordination, not just liaison.

5. To be credible, the ESRB's membership and its voting structure needs to reflect the entire financial sector. There is concern at present that the banking sector will be over represented on the board, or rather that other sectors will be underrepresented. This crisis originated in the banking sector. The next might start elsewhere. The City believes that national supervisors from all financial sectors (securities, banking and insurance) should participate in the meetings, not least those authorities overseeing the main financial and banking markets.

6. In relation to the chairmanship of the ESRB, the City supports the European Council conclusions requiring this post to be elected by the General Council of the ECB, as it is important for the ESRB to be viewed and to act as an independent body for the EU as a whole, irrespective of euro-zone membership. Furthermore the ESRB should be designed such that it can raise concerns to financial stability stemming from across the whole of the EU financial system, including monetary policy, always respecting the independence of the central banks and supervisors involved.

7. Whether the ESRB would have prevented or ameliorated the recent crisis is hard to say but, at the very least, it would have given a better chance at identifying the global nature of the problems and allowed a quicker more coordinated response.

MICRO PRUDENTIAL

8. The City supports the principle of promoting convergence (and harmonisation where possible) to ensure consistency of rules, however the European System of Financial Supervisors (ESFS), which builds on the current Lamfalussy structure, should not seek to overrule supervisory decisions made by national regulators which have been taken on the basis of these rules. It will, therefore, be important to define the demarcation of powers between national and EU authorities.

9. A single rule book should be applied when the benefits of changing existing national rules to make them identical outweigh the costs. Proportionality tests must be applied rigorously both in relation to changes in implementation of existing Community legislation and to new Directives.

10. Any binding powers should be exercised as a last resort, only after full analysis and discussion has failed to deliver agreement; they must not interfere with specific individual supervisory decisions made in accordance with EU law. Whether the decision should be taken by QMV or simple majority is less important than the expertise of the decision takers. Every decision should be taken on a purely technical basis.

11. The City remains concerned at the timetable envisaged for the development of these proposals. The City, however, recognises the pressure to deliver a workable solution to the further development of EU financial markets.

November 2009

Written evidence submitted by JWG

I am the CEO of JWG, a financial services think-tank which works with regulators, investment firms and their information technology supply chain to help determine how the right regulations can be implemented in the right way.

Since 2006, JWG has worked with over 100 financial institutions, 12 trade associations and 50 technology vendor firms. We have been actively engaged with the European Commission, level three committees, the FSA and EU, UK and international trade associations and standards groups.

In order to aid your committee's inquiry into proposals for European macro and micro prudential financial regulation, I would like to share some of the findings from our recent research on the rather large challenges inherent in establishing global regulatory oversight.

GETTING MACRO PRUDENTIAL OVERSIGHT RIGHT

Despite calls for the G20 to conduct a cumulative impact assessment before agreeing a path forward, the newly-minted Financial Stability Board (FSB) appears to be engaged in a regulatory "race to the top", which pits the rule makers both against each other and against the banks in a bid to build a macro view of systemic risk. Of all the proposed regulatory changes, macro prudential oversight (MPO) is the most ambitious yet, we believe, the least understood.

The implication of the G20's 93-point action plan for investment firms is that they must now extract more data from more sources on both an ad hoc and a periodic basis. That data must be scrutinised and retained for longer periods of time, and possibly shared more widely.

For the regulators, this poses an enormous data quality challenge. Individually, each regulator needs to be able to make sense of the information it has asked for and then share a common understanding across jurisdictions which have different languages, laws, tax codes, cultures and business systems. Effective supervision relies on uniform translation of oversight information which must be captured, aggregated, normalised, validated, enhanced, analysed and reported over long periods of time.

There must be a clear consensus of what information is necessary and sufficient for successful oversight, agreement of what "good quality data looks like" and agreement on how that information should best be transmitted. Without this common understanding between market participants, we run a real risk of managing risk via the information systems rule of "garbage in, gospel out" where computed results become the unquestionable truth.

In order for the global regulatory community to get the right data with the appropriate level of quality, they will need to agree procedure manuals to guide and inform firms about what information standards are to be used under which circumstances. According to analysis from the European Commission supporting the proposed Omnibus Directive (2009/0161), there are in excess of 50 missing technical standards that are required to effectively share the information required by the CRD, MiFID, MAD, AML and eight other existing EU financial services regulations.

These standards will not be easy to implement as there are currently many differing ones being used by firms and vendors. As you may be aware, different firms have different naming conventions for their reference data, a point which emerged during the Lehman's fallout as firms scrambled to discover their total exposure to each legal entity. There are also different methods of describing financial instruments which may be equally idiosyncratic.

To complicate matters further, recent regulatory policy initiatives are now asking for detailed reporting of what may be ambiguous concepts, ie, those that have slightly different meanings for each segment of the market. For example, a retail bank may focus on its customers, whereas an investment firm will think of counterparties. Each will need a naming convention to describe what, in each case, is a legal entity, but which is characterised for the purposes of the business relationships in different forms and tracked in different formats. JWG's investigations have revealed that there is a growing commonality of requirement for data to be connected and shared, not only internally, but externally too as more visibility is requested by the Supervisory Colleges, European Supervisory Agencies, the European System of Financial Supervisors, and European Systemic Risk Board.

Sticking with the customer reference data example JWG's membership is concerned about the operational implications of:

- FSCS requirements for "single customer view" (ie, PS09/11);
- Large exposure requirements to track "economic interconnectedness" (CEBS CP26);

- Liquidity requirements for funding (ie, PS09/16 FSA 053) or funding concentration (ie, FSA 051);
- Carbon Reduction Commitment reporting by asset owner (CRC Order 2010); and
- Living will information (eg, BCBS cross-border CP re lists of counterparties).

The full picture of all the regulations is far more complex and its implications are of real concern.

In addition to the requirements of specific regulations, overarching arrangements which are robust, practical, efficient and integrated need to be put in place. Information sharing must be possible within the EU, from outside its borders and throughout the members of the G20. While the focus might be on the EU, it must be remembered that regulators and agencies in other countries may also need to access and use the information. In turn, their information will need to be accessible to the EU regulators in a form which is readily understandable.

THE IMPACT OF THE CURRENT APPROACH

Whilst the industry is already engaging in the discussion of how to align its view point, the complexity, speed and technical difficulty of creating an integrated picture of risk is mind boggling.

Resources are being wasted as both firms and regulators devote man years to solving these problems in silos. The traditional methods of agreeing detailed technical standards and quality measures are being overridden by the need to comply with unrealistic timelines. Often, existing policy-focused associations do not have the skills, time and resources to present the views of their memberships. Aggressive targets are forcing corners to be cut and common business rules, data requirements and infrastructure capabilities are not fully understood. In the absence of meaningful guidance, and despite scarcity of resources, every major firm is deploying scores of analysts in an isolated and uncoordinated fashion to define requirements, engage the infrastructure, negotiate with vendors and scope solutions. Across Europe alone, there are hundreds of players that need to coordinate their implementation roadmaps to make the omnibus work.

Without a clear mandate to establish an understanding of “what good macro prudential oversight looks like” at senior level within the firms, the FSB, the International Monetary Fund, the European Commission, the FSA and global standards bodies, we could well find ourselves overwhelmed by the data tsunami of 2010. This storm might prevent the fulfilment of the G20’s commitments and force difficult discussions between the taxpayers, their representatives and the financial services supply chain as:

- businesses suffer from bad policy (eg, excessive liquid asset buffers, regulatory capital);
- compliance costs increase (eg, more reporting, fines);
- business is disrupted (eg, regulatory projects, inability to complete growth projects);
- resources are strained as cutbacks have imposed operational stresses;
- the cost to the consumer goes up (ie, pension funds suffer, businesses funding remains challenging) as a result of the banks’ increased costs of complying with these new requirements; and
- there is global uncertainty as intensive regulatory locations lose out through regulatory arbitrage.

We feel that it is important to draw breath now and clearly articulate the problems we need to solve and the solutions for the industry to practically implement the required changes.

MOVING THE DIALOGUE FORWARDS

Both the costs and the benefits of this initiative could be large but we need a realistic vision, blueprint and timeline. Our research has identified the major strategic questions and tactical challenges to any oversight strategy and is summarised in the Appendix. We are now in a position to ask the right questions—we know what we don’t know. However, we are currently unable to give full, considered solutions to any of these “known unknowns” and this presents a real implementation risk to the EU’s plans.

At the extreme, overcoming the practical hurdles to building a macro prudential system could require a fundamental restructuring of how the industry’s information assets are developed, maintained, owned and paid for. Even if the requirements for MPO can be agreed upon, there are countless vested interests in play at national, regional and global levels. If MPO is to succeed, a proactive approach to aligning the many stakeholders must be underway by early 2010.

The world has been scorched by the financial crisis and is keen to see new fire prevention methods put in place quickly. We hope that a high profile committee like yours will take a lead in raising the awareness of these issues and call upon the authorities at national, European and international levels to develop a better understanding of the roadmap and what “good looks like” at the end of the journey.

There is a real risk that if we get this wrong, not only will the world be engulfed by faulty data, but we will further damage an already weakened industry and MPO will be branded as a failure politically, to be tossed aside until another crisis forces a renewed focus somewhere down the line. Rather than letting the responsibility fall to a few organisations who happened to start first, it would benefit the industry, and the global economy as a whole, to engage in an adult discussion—involving all who would be affected—about how to reach a comprehensive, efficient and effective solution.

Hundreds of man years effort from real domain experts in the leading banks is required to get this right. Having worked with the firms, the regulators, the supply chain and the industry associations, JWG has observed the individuality of multiple data silos—in all types of organisations—leading to real difficulties in addressing the challenges of reporting or responding to the request for new levels of data interconnectedness. We believe that JWG is well placed to facilitate some joined-up thinking which might have real economic and administrative benefit at a later stage.

We recognise that these are busy and challenging times but we feel that taking some time now to enter into structured dialogue would be of real benefit to all parties. We would, of course welcome the opportunity to explore these issues in more detail.

13 November 2009

APPENDIX

The Macro Prudential Oversight Roadmap Checklist

What has the G20 asked for?	— Who owns the vision?	— What are the key milestones?
What does it mean?	— What is the mission?	
	— What is the purpose of systemic oversight?	— What are the service levels required across the supply chain to make MPO work?
	— Do we have an agreed definition of the objectives?	— What explicit legal mandate is required to ensure all the actors complete their objectives and what will be the penalties of non-compliance?
	— What changes are implied to the infrastructure by introducing it?	
The problem	— What is the definition of a systemic risk in practical terms: what factors are we looking for?	— What information flow is needed to detect such a risk: what data and to whom?
		— How will we know the data is of high enough quality to support MPO requirements?
		— What is the right governance structure to get us to an effective solution?
The barriers	— What is a “good enough” view of a systemically important firm’s risk?	— What information is needed from whom, to whom and by when?
	— Do we require validation of a firm’s systemic risk data, information architecture and governance against some sort of standards?	— How should quality measures be established, maintained and enforced?
	— How should these same standards be applied to the regulators?	— How should the many standards be created in a way which fosters and encourages their rapid adoption and success?
Risks/costs	— How much does the G20 want to spend to get this right?	— What costs and benefits will each stakeholder in the supply chain incur or reap?
	— What is a realistic timeline?	
	— How will we know when we get there?	— How and when will they incur or reap them?
The roadmap	— What is the right blueprint: how will the information be shared throughout the marketplace?	— What combination of new standards and reports is necessary and sufficient to ensure that adequate quality data is available for the purposes of MPO?
	— When is the implementation deadline and how much will all this cost?	
	— How is the implementation programme monitored and controlled?	— What group of people is best suited to create these new standards and report?

Written evidence submitted by Jane Welch, Visiting Research Fellow in European Financial Services Law

This paper focuses on two specific issues arising out of the above proposals. It should not be read as an implied endorsement of the other provisions contained in the draft regulations.

LEGAL BASIS OF THE DECISION ENTRUSTING THE ECB WITH SPECIFIC TASKS

The decision is based on Article 105(6) of the EU Treaty which allows the Council to confer on the ECB “specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions” but “with the specific exception of insurance undertakings”. This unambiguous wording makes it difficult, to say the least, to see how the ECB can be entrusted by the ESRB with the task of collecting information about insurance undertakings for the specific purpose of improving macro-prudential supervision.

There is a second difficulty with the use of Article 105(6) as a legal base for the ECB decision. Both the ESRB and ESA regulations are based on Article 95 of the Treaty which is designed to facilitate the establishment and functioning of the internal market. As such, measures adopted under Article 95 are “EEA relevant” and would normally apply in due course to the EEA EFTA states—Norway, Iceland and Lichtenstein. But the EEA Agreement does not cover participation in economic and monetary union and accordingly EEA states are not bound by the monetary policy provisions of the EU Treaty (including Article 105).

Although the distinction between internal market activities and other EU activities has become increasingly blurred in recent EU legislation, the EEA Agreement relies unfortunately on such a distinction being drawn. So while the draft ESRB regulation and the draft ESA regulations are clearly relevant to the EEA states, it is difficult, if not impossible, to see how the ECB, acting on the basis of Article 105(6), can exercise any powers in relation to the EEA states. This would be unfortunate, to say the least, since the collapse of the Icelandic banks has highlighted the importance of including EEA financial institutions in macro-prudential oversight of the financial sector.

It seems that both problems could be solved by using Article 95 as the legal base for the ECB decision.

CONFIDENTIALITY

Analysis of the confidentiality provisions in the various draft proposals involves a balancing act between the need to ensure that information is kept confidential and used only for the purposes specified and agreed in the legislation and, on the other hand, the need to ensure that the persons receiving confidential information can use and disclose it legitimately in the performance of their functions, both under the new arrangements and under existing legislation.

If, for example, the FSA were to obtain, through its membership of the ESRB, information about the activities of a US bank operating in the UK and other Member States, it could well want to raise issues of concern with the relevant US supervisory authorities. It is not clear that Article 8(2) of the ESRB regulation provides the necessary cover. It provides that information received by “members of the ESRB” (who are presumably the same as “members of the General Board of the ESRB”—the term used in Article 8(1)) may only be used in the course of their duties and in performing the tasks set out in Article 3(2). If the duties referred to are limited to those set out in Article 3(2), this would not protect a national supervisory authority who wanted to discuss an individual institution with a third country supervisor. On the other hand, if the intention is to allow members of the ESRB to use confidential information in the course of their duties under other EU legislation, this should be made clear.

The professional secrecy provisions in Article 8 are complicated by the unwieldy structure and size of the ESRB. Given the sensitivity of the information likely to be generated, it is essential that the professional secrecy provisions are sufficiently robust to act as a credible deterrent, though this may seem a somewhat vain hope in the context of a body containing over 50 members and covering 27 Member States.

Article 8(1) of the ESRB regulation imposes a duty of professional secrecy on members of the General Board of the ESRB and any other person who has worked “for or in connection with” the ESRB (including the relevant staff of Central Banks, the Advisory Technical Committee, ESAs and competent national supervisory authorities). Members of the Steering Committee are not expressly mentioned presumably on the grounds that they are a subset of the General Board, nor are members of the ECB secretariat. In the latter case this is presumably because the Secretariat is subject to separate professional secrecy provisions under the ECB decision, although the ECB President and Vice-President will be covered by the ESRB professional secrecy provisions in their capacity as members of the General Board.

The Secretariat is not part of the ESRB; instead it is clearly part of the ECB and, as such, information gathered by the ECB staff allocated to the secretariat will inevitably be disclosed to other staff in the ECB, who may be involved in processing and analysis of the information in accordance with Article 2 of the ECB Decision, some of which may relate to individual financial institutions. Article 6 of the Decision merely requires the ECB to establish internal mechanisms and rules to protect data collected on behalf of the ESRB and goes on to state that the ECB staff “shall comply with the applicable rules relating to professional

secrecy". If this is intended to refer to the internal ECB rules, it is clearly unsatisfactory, since it would impose a much weaker and ill-defined duty of confidentiality than that imposed by the ESRB regulation. Moreover, it is unclear whether any sanctions would apply for breach.

13 November 2009

Written evidence submitted by the Hedge Funds Standard Board

The Hedge Fund Standards Board (HFSB) was set up to act as custodian of the Best Practice Standards published by the Hedge Fund Working Group in 2008 and to promote conformity to the Standards. It is also responsible for ensuring that they are updated and refined as appropriate. Almost 60 managers from the UK and abroad—totalling over USD 200BN in assets under management—have already committed to the process of the HFSB, and more are expected to sign up to the Standards over coming months. The HFSB expects its Hedge Fund Standards to be widely adopted and an increasing number of investors to use the Standards in their due diligence. It is important that policy leaders trust that the HFSB will implement this market based regime with the industry and encourage adoption as well.

The Hedge Fund Standards Board (HFSB) is pleased to respond to the Treasury Committee inquiry into the European Commission's proposals for financial regulation and supervision and, in particular, the detailed proposals for a European Systemic Risk Board and three European supervisory bodies: a European Banking Authority, a European Insurance and Occupational Pensions Authority and a European Securities and Markets Authority.

This paper is structured around the areas the Committee has highlighted in its press announcement and focuses specifically on issues in relation to regulation of the hedge fund industry.

THE INTERACTION BETWEEN EU, NATIONAL AND INTERNATIONAL REGULATORY AND SUPERVISORY ARRANGEMENTS

The set up and the degree of centralisation of regulatory and supervisory arrangements will depend on the nature of the activity. There is no single approach applicable across all areas of regulatory and supervisory activity. The following differentiates between activities in relation to systemic concerns (1.), vs regulation and oversight of individual industries (2.).

1. When dealing with issues in relation to systemic risk, supervisory arrangements and activities at European level are required given the cross border nature of systemic issues. However, it is important to highlight that this activity will likely require a more holistic approach than just focussing on specific sectors such as banking, but will require a cross sections of the entire economy. The toolkit required when assessing systemic issues will likely differ significantly from the regular oversight of individual institutions. Interaction with national regulators (as well as international bodies) will be required for data collection and aggregation purposes.

2. In relation to the regulation of individual industries, local regulators tend to have the best and most detailed understanding of their respective industries. Here, the subsidiarity principle needs to be observed.¹

The current debate on the AIFM Directive is an example for a questionable centralization of powers in Brussels.

- The scope of the Directive is very wide, which has given rise to discontent in many member countries that their respective industries are not adequately catered for by the Directive, and might even be significantly hurt.
- For the UK, the hedge fund industry is one example of a severely affected industry, but other countries face their own issues (such as German open ended real estate fund managers). For the hedge fund industry, the majority of the European industry (~80%) is based in the UK, and the industry is already regulated by the UK FSA.
- There has been no case of failure or weakness in the current regulatory set up of regulation of hedge funds, on the contrary, the UK FSA is considered to be among the most skillful, experienced and also advanced regulators in the world for this market segment. In particular, the UK FSA has started to look into issues in relation to systemic risk in the context of Hedge Fund activity long before the crisis started (eg Prime Brokerage survey).

It is now hard to argue that a centralized approach to regulate this industry from Brussels will be superior in achieving public policy objectives than the hands on approach of the local regulator.

¹ Subsidiarity is a key pillar of European policy making, whereby it is intended to ensure that decisions are taken as closely as possible to the citizen and that constant checks are made as to whether action at Community level is justified in the light of the possibilities available at national, regional or local level. Specifically, it is the principle whereby the Union does not take action (except in the areas which fall within its exclusive competence) unless it is more effective than action taken at national, regional or local level. It is closely bound up with the principles of proportionality and necessity, which require that any action by the Union should not go beyond what is necessary to achieve the objectives of the Treaty.

The Banking industry is an example, where local regulators are in charge, while banks are allowed to operate in other European jurisdictions in the context of a European passport.

A final point about the hedge fund industry puts the regulatory approach in a different light: this is one of the most entrepreneurial and innovative industries that one can imagine. Hedge funds only survive if they outperform, and this requires a permanent search for innovation: new ways of investment, new strategies of value creation. These innovations are then copied by the whole asset management industry and we all benefit from them. And all of this happens in an incredibly competitive market, where investors are fully in charge.

Hedge funds are, in many ways, the Silicon Valley of finance. One can wonder whether Silicon Valley would ever exist if the law were to regulate in detail the activities of these firms, including the compensation of successful entrepreneurs.

In summary, the HFSB would favor that more powers are given to the national regulators in particular in the context of innovative industries such as the hedge fund industry. More generally, we believe that national regulators are best positioned to identify the required measures in the context of their respective national alternative investment management industries.

THE COMPOSITION AND INTERNAL STRUCTURES OF THE SUPERVISORY AUTHORITIES AND THE ESRB, AND WHETHER THE POWERS PROPOSED FOR THESE BODIES ARE APPROPRIATE

The HFSB is not convinced that a significant concentration of powers is needed at the European Commission. There is significant risk that the quality of regulatory oversight will decrease, ultimately leading to higher risks for all market participants, including investors and depositors.

- To avoid this, national regulators will need to maintain significant powers. (1.)
- Private initiatives such as the HFSB, which represent a complement to legislation, need to be strengthened. (2.)

The following points elaborate on the second conclusion above, and highlight the importance of Standard setters such as the HFSB as part of the regulatory architecture.

- It has long been recognized that relying on legislation alone is not always effective. The reasons for this include the slow pace of the legislative process as well as the inefficiency of relying on the courts as the only mechanism to address issues of compliance and sanction.
- consequently systems of regulation have been created which are designed to be more flexible and which enable behaviours to be shaped through a combination of regulatory direction, intervention and sanction. Such systems include Principles, Rules and Standards (such as the Hedge Fund Standards).
- *Standards* are typically less granular than rules, but generally set out the principals of behaviour required in greater detail than can be achieved in the legislation or the principles themselves. They are specific to particular areas of business such as Hedge Funds or to an area where detailed rules themselves are impossible to draw up in a meaningful way like Governance. Standards are an appropriate way to express required behaviours in fast moving areas of business and to ensure that such principles of behaviour keep pace with the development of that business. They can allow for exceptions whilst still aiming at the same behavioural outcome intended by the legislation and the principles. The alternative would be for overly detailed rules in order to accommodate exceptions etc. But this can lead to complexity, rigidity and to parties circumventing the spirit of the rules by adapting new definitions, technical business models or escaping to jurisdictions where the rules do not apply.

THE PROPOSALS' EFFECT ON THE COMPETITIVENESS OF THE EUROPEAN FINANCIAL INDUSTRY IN GENERAL AND THE CITY OF LONDON IN PARTICULAR

This answer relates specifically to the Hedge Fund industry:

Hedge Funds are a key component European financial markets. They are significant liquidity providers, contribute to efficient price discovery, provide capital and innovate new ways of investing (and these innovations are then copied by mainstream investors), and most importantly, they provide value for their investors.

The nature of the industry is very entrepreneurial, the compensation model is very strongly linked to performance, and when performance is inadequate, the sanction is swift: investors are sovereign, they withdraw their money quickly and hedge fund managers suffer accordingly, often going out of business. There is hardly an industry which is more rigorously subject to the market test, and where the sanction for mediocrity is more rapidly felt.

It is important to ensure that this entrepreneurial "silicon valley" of financial markets is not hampered, and that barriers to entry into this area of activity are not unnecessarily raised. Current regulatory efforts in the alternative investment area raise significant concerns that this innovative activity will be impaired.

The impact would be felt beyond the jobs (and continuous new job creation) in this area of finance in the City of London and elsewhere in Europe: This would lead to less efficient, less complete and less attractive capital markets in Europe.

In order to preserve the competitiveness and quality of European capital markets, it is important that all regulatory initiatives are anchored in a solid intellectual foundation, such as the findings in the De Larosière Report. It is also important that despite the perceived urgency and political pressures in light of the recent financial crisis, principles of better regulation should be permanently observed and followed.

18 November 2009

Written evidence submitted by the City of London Law Society

The City of London Law Society (CLLS) represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the Treasury Committee inquiry into proposals for European Macro and Microprudential Financial Regulation has been prepared by the CLLS Company Law Committee.

1. SUMMARY

- This submission is concerned solely with the proposal to include within the remit of the European Securities and Markets Authority (ESMA) the Community legislation that deals with companies, the holders of securities issued by them and their directors (and other senior managers). This includes:
 - the rules relating to listing of securities;
 - rules relating to prospectuses;
 - disclosure obligations of listed companies, both periodic and *ad hoc*;
 - obligations of shareholders to disclose their interests;
 - the regulation of takeovers under the City Code on Takeovers and Mergers; and
 - the rules relating to market abuse.
- The new European architecture for Financial Regulation is being brought forward as a response to the “real and serious risks to the stability of the internal market” created by the financial and economic crisis.² The areas of regulation with which we are concerned (“securities regulation”) are not in any way implicated in the financial crisis and there is no suggestion in any of the Commission publications on the proposals that they are. No attempt has been made to articulate a proper justification for the imposition of a new layer of regulatory responsibility for these areas, an approach which will inevitably undermine the authority of the national regulators (in the UK, the FSA and the Takeover Panel).
- The main thrust of the proposals is to establish a closely harmonised system of financial regulation³ which covers the supervision of financial institutions and markets, including prudential supervision of financial institutions and the “conduct of business regulation” of financial institutions. We offer no comment on that. We are, however, very concerned that the proposals would result in a major change in the approach to securities regulation without any analysis of the need for that change or its likely consequences. We believe that conferring on ESMA, as a European “super-regulator”, the role of rulemaker, with powers of direct intervention, would represent a significant change in the framework of securities regulation that may threaten the established working of the capital markets in the UK.
- In the area of securities regulation, the legislation has adopted different approaches according to the objectives of the specific legislation, complying with the principle of subsidiarity. This has allowed flexibility where appropriate for the rules to respond to local market dynamics. Although the proposals do not indicate that there would be an immediate major change in the framework for securities regulation, adopting a common approach to both financial regulation (with its core aspiration of a “single rule book”) and securities regulation, will shift the geography significantly

² Paragraph 4 of the Explanatory Memorandum.

³ In its response to the House of Lords EU Committee Report *The future of EU financial regulation and supervision*, the European Commission explained that the proposal of the European System of Financial Supervisors (ESFS), which includes ESMA, was “the supervision of individual financial institutions”, with no mention of the wider regulatory issues with which we are concerned (C(2009)8014, 26 October 2009).

towards greater harmonisation with an inevitable effect over time on securities regulation. There may be a case to be made for greater harmonisation in areas of securities regulation but no attempt has been made to present that case.

We suggest therefore that if the proposals as a whole are adopted, ESMA's role in the areas we have identified should be confined to the role CESR currently performs. If thought appropriate, there could be a subsequent consultation and debate of the merits of an expansion of ESMA's role of these areas of regulation.

- The systemic problems recently experienced are not a result of failures in the system of securities regulation and there is no justification for proceeding with this step change to increased harmonisation with the same urgency that may be required in relation to financial regulation. Any such change should be the subject of proper consideration and full consultation with all stakeholders. The fact that there has been some prior consultation on the wider de Larosière and Commission proposals has not helped: those proposals focus on significant financial market issues, which of course have been the focus of responses. Given the excellent consultation processes which led to the current regime, it would be highly regrettable to introduce an entirely new framework on the back of unrelated concerns about banks and financial institutions.
- If, contrary to our views, securities regulation is brought within the scope of the new architecture, proper consideration must be given to the essential differences between the regulation of individual regulated entities (which is what financial regulation involves) and regulation that provides a framework for numbers of unregulated entities and individuals to interact (which is what securities regulation deals with).

A simplistic “one size fits all” approach will not be appropriate. In particular the powers of direct intervention (Article 9) and to impose emergency measures (Article 10), should be limited to areas of financial regulation.

- The proposed inclusion of takeovers regulation within the scope of ESMA's powers requires particular attention. The Takeovers Directive was the result of many years discussion and negotiation and its minimum harmonisation approach reflected a recognition of the very considerable differences between Member States in their regulation of takeovers. For the UK, it was very important that the Takeovers Directive did not interfere in the smooth operation of the well established and well respected system operated by the City Panel on Takeovers and Mergers. That objective was largely achieved. CESR's only role in relation to takeovers regulation is to provide an informal framework for relevant national regulators to exchange views and information. No justification has been advanced for bringing takeover regulation within the remit of ESMA and in our view it should not be.

We see no benefit, and considerable risks, if this important area of regulation is brought within the scope of ESMA's authority.

2. SCOPE OF OUR CONCERNS

We are concerned solely with the proposals as they relate to the European Securities and Markets Authority (ESMA). ESMA is to be given responsibility for a wide range of areas of regulation. These include “financial regulation”:

- regulations governing the operation and functioning of financial markets;
- regulation of the activities of credit institutions, insurance undertakings and investment firms and, prospectively, alternative investment fund managers and credit rating agencies (which we refer to as “financial institutions”).

In addition, ESMA would have responsibility for “securities regulation”, including:

- regulation of market abuse;⁴
- obligations of issuers of securities to make disclosures, both *ad hoc*⁵ and on a regular basis;⁶
- obligations of holders of shares to make disclosures regarding their interests;⁷
- requirements for publication of prospectuses;⁸
- requirements for admission to listing;⁹
- regulation of takeovers.¹⁰

⁴ Market Abuse Directive (other than Article 6).

⁵ Article 6 of the Market Abuse Directive.

⁶ Transparency Directive.

⁷ Transparency Directive.

⁸ Prospectus Directive.

⁹ Consolidated Admissions and Reporting Directive.

¹⁰ Takeovers Directive.

3. BACKGROUND—THE CASE FOR CHANGE

3.1 The origin of the current proposal lies in the Report of the High Level Group on Financial Supervision in the EU chaired by Jacques de Larosière. That Group's terms of reference were:

"The Group is therefore requested to make proposals to strengthen European supervisory arrangements covering all financial sectors, with the objective to establish a more efficient, integrated and sustainable European system of supervision.

In particular the Group should consider:

- how the *supervision of European financial institutions and markets* should best be organised to ensure the prudential soundness of institutions, the orderly functioning of markets and thereby the protection of depositors, policy-holders and investors;
- how to *strengthen European cooperation on financial stability oversight*, early warning mechanisms and crisis management, including the management of cross border and cross sectoral risks;
- how supervisors in the EU's competent authorities should cooperate with other major jurisdictions to help *safeguard financial stability* at the global level." (emphasis added)

In line with these terms of reference, the Report¹¹ discussed only the prudential supervision of financial institutions and some other aspects of financial regulation. It contained no explanation of why securities regulation should be brought within the architecture it proposed.

3.2 The Commission Communication in May 2009¹² describes the case for macro and micro-prudential reform. Its focus was on financial regulation, not on securities regulation, and it did not set out any justification for the changes it proposed in relation to securities regulation. For example:

"The focal point for day to day supervision would remain at the national level, with national supervisors remaining responsible for the supervision of individual entities, for example with respect to capital adequacy."

and

"... the European Supervisory Authorities could also be empowered to adopt decisions directly applicable to financial institutions in relation to requirements stemming from EU Regulations relating to the prudential supervision of financial institutions and markets as well as the stability of the financial system."

3.3 The language used in the Commission Communication is in terms of "supervision"¹³ and seems to be focussed on the regulation of financial institutions and not on the wider regulation of financial markets and their participants. The approach up to now in relation to securities regulation has been to allow national authorities to operate their national rules that implement the Community legislation, an approach that reflects the continuing diversity of financial markets that each operate under different structural conditions. Over time there may be movement towards fully harmonised markets but we do not believe a step-change in approach is appropriate, or that adequate (or any) justification for that change has been advanced.

3.4 As there has been no attempt to justify the inclusion of securities regulation within the architecture (other than by sweeping comments about the benefits of harmonisation), there has been no attempt to justify the need for urgency in doing so. As there is no need to move quickly in the area of securities regulation, we strongly urge caution and suggest that time be taken to allow a proper debate. It would be possible to achieve this, without impeding the establishment of the architecture, by proceeding with the establishment of ESMA and conferring on it in relation to securities regulation the roles and responsibilities currently performed by CESR.

Implementation without broader and substantive consultation (and greater justification being given) will fail to meet the Commission's "Better Regulation" objectives.

4. EFFECT OF THE PROPOSALS

4.1 The principal powers of the ESMA that are relevant (and which we think are unnecessary in relation to securities regulation) are:

- the power to impose technical standards (Article 7);
- the power to issue guidelines and recommendations (Article 8);
- the direct intervention power (Article 9); and
- the power to require action in emergencies (Article 10).

¹¹ Report of the High Level Group on Financial Supervision in the EU (Brussels, 25 February 2009).

¹² COM(2009)252 final 27 May 2009.

¹³ Eg *The focal point for day to day supervision would remain at national level* (Communication, paragraph 4). *The European Supervisory Authorities should ... contribute to the emergence of a common supervisory culture and consistent supervisory practices (ibid).*

4.2 *Technical standards*

The power for ESMA to impose technical standards under Article 7 applies in relation to “the areas specifically set out in the legislation referred to in Article 1(2)” (Paragraph 1). The scope of this is unclear in the proposed Regulation. Neither Recital 14 nor paragraph 6.2.1 of the Explanatory Memorandum shed much light on what is intended. Paragraph 6.2.1 refers to “an effective instrument to strengthen Level 3 of the Lamfalussy structure” but refers to “areas specified” in the principal legislation. Recital 14 refers to “areas defined by Community Law”. Paragraph 6.2.1 refers to “issues of a highly technical nature” while Recital 14 refers to “technical standards, which do not involve policy choices”. However, it appears from the Commission Staff Working Document¹⁴ that the intention is to include areas already identified in the primary legislation as having scope for Lamfalussy Level 2 implementation and other areas identified in the Working Document and which are now set out in the proposed Amending Directive.¹⁵ In relation to securities regulation these relate to only a few matters.¹⁶ If the intention is that the technical standards should only relate to issues of a highly technical nature, the Regulation should make that clear.

4.3 If the conclusion in paragraph 4.2 is correct, areas that may be covered by technical standards would include:

- (i) MAD:
 - the definition of “inside information”;
 - the requirement for disclosure of information and for delaying disclosure.
- (ii) Transparency Directive:
 - details relating to the notification of interests in shares.
- (iii) Prospectus Directive:
 - exemptions from the obligation to publish a prospectus in connection with a takeover or merger;
 - the information to be included in a prospectus.
- (iv) Takeovers Directive
 - (possibly) the requirements for the information to be included in an offer document.¹⁷

The Appendix contains a complete list of the areas where implementing measures are contemplated and where, therefore, technical measures may be adopted.

4.4 The Commission’s publications in connection with the proposal contain a number of references to a “single rulebook” (see, for example, paragraph 4 of the Explanatory Memorandum)¹⁸ but we do not see how that ties in with the proposed Regulation. We assume that the “single rulebook” is an objective confined to financial regulation, as we assume it is to be achieved through adoption of technical standards under Article 7 and there is no framework for the adoption of a single rulebook in relation to securities regulation. We think it important that it should be made clear that the single rulebook is not an objective in relation to securities regulation.

4.5 *Guidelines and recommendations*

Article 8 would confer on ESMA the power to adopt guidelines and recommendations. This is similar to the role currently performed by CESR but is strengthened by the requirement that competent authorities “make every effort to comply with those guidelines and recommendations”. If a competent authority does not apply ESMA’s guidelines or recommendations it must notify ESMA and give reasons. There is a significant risk that giving ESMA’s guidelines and recommendations this additional authority will be counter-productive, as the process for formulating and adopting binding guidelines and recommendations will inevitably become more cumbersome and will take longer. In the context of securities regulation, CESR’s non-binding guidance has been effective in promoting more consistent practical application of the regulations and we do not see any case for change.

If Article 8 powers are retained in relation to securities regulation, we would be concerned that there is no mention in the existing draft of any requirement for public consultation (in contrast to the position in relation to technical standards).¹⁹ If authoritative guidelines are to be provided by ESMA, it is essential that a proper consultation process is undertaken.

¹⁴ SEC(2009)1233.

¹⁵ 2009/0161(COD).

¹⁶ See the Appendix, where the additional areas for technical standards are identified.

¹⁷ It is not clear that the possibility of rules being adopted for the application of Takeovers Directive, Article 6(3) can be brought within the procedure for adopting technical standards in Article 7. Under Article 6(4) of the Takeovers Directive, the adoption of such rules is required to follow the procedure as set out in Article 18.

¹⁸ See also the Commission Communication (COM(2009)252) paragraph 4.2, which refers to “a single set of harmonised rules”.

¹⁹ Article 7(2).

4.6 *Direct intervention*

Article 9 would confer on ESMA powers to intervene directly in the way Community laws are applied by national regulators. It contemplates a three stage process:

- (i) first, (having investigated) ESMA may address a recommendation setting out action required to comply with Community law;
- (ii) second, a Commission decision requiring the competent authority to take action to comply with Community law; and
- (iii) subject to two important conditions, ESMA may adopt a decision addressed to a financial market participant. The conditions are:
 - (a) a remedy “in a timely manner” must be necessary to “maintain or restore neutral conditions of competition in the market or ensure the orderly functioning and integrity of the financial system”; and
 - (b) the non-compliance must be in respect of Community Laws that are directly applicable to financial market participants.

This process is potentially time-consuming (the Commission has three months and may take an additional month to take any Decision required of it at the second Stage). It appears that decisions addressed to financial market participants must relate to Community laws that are “directly applicable” by virtue of being set out in Regulations (see Recital 20). However, there is academic debate whether other Community legislation (eg Directives) may in some circumstances be directly applicable. Given the importance to financial market participants of knowing what authority an ESMA decision would have, the Article should refer specifically to “Regulations”.

4.7 With the broad scope proposed, this process is objectionable as a matter of principle. It disturbs the existing balance between Community institutions and Member States and their national agencies. The primary determination of a failure to comply with Community Law will not be a judicial determination by the Court of Justice but will be an executive decision of the Commission.²⁰

4.8 Article 9(1) provides:

“Where a competent authority has not correctly applied the legislation referred to in Article 1(2), . . . the Authority shall have the power set out in paragraphs 2, 3 and 6 of this Article.”

The legislation referred to includes Directives, Regulations and Decisions. In its reference to Directives the Article must be regarded as legally flawed. It is for Member States to implement Directives and competent authorities do not “apply” Directives, they apply the laws adopted by Member States to implement them. We question whether the Commission can, by Regulation, take power to intervene directly in this way in Member State’s decisions as to implementation of Community Law. It seems from the sub-clause omitted from the quotation above (“in particular by failing to ensure that a financial market participant satisfies the requirements laid down in that legislation”) that the intention was to limit the scope to the enforcement of rules for financial regulation (presumably the single rulebook for financial institutions). If that is so, the Article should be amended accordingly.

4.9 Even if limited to the “enforcement” of directly applicable provisions (including technical standards adopted under Article 7) the process set out in Article 9 raises some significant legal issues, by making determination of the legality of decisions of competent authorities a matter of executive decision and not judicial determination. A person subject to a relevant provision will face an unacceptable level of uncertainty as to its legal obligations in the event of a disagreement between the relevant competent authority and ESMA (and the Commission). The Commission may require the competent authority to adopt a position with which the competent authority disagrees while the person concerned seeks redress against the competent authority concerned in its national courts.

4.10 *Emergency measures*

Article 10 provides a procedure for the adoption of measures in emergency situations:

- (i) it is for the Commission to determine that an “emergency situation” has arisen;
- (ii) ESMA may then adopt individual decisions addressed to competent authorities to take action; the action required must be “in accordance with the legislation referred to in Article 1(2)” and must have as its object addressing risks:
 - (a) that may jeopardise the orderly functioning and integrity of financial markets; or
 - (b) the stability of the whole or part of the financial system,
 and must do so “by ensuring that financial market participants and competent authorities satisfy the requirements laid down in [the legislation referred to in Article 1(2)]”;

²⁰ Art 226 EC requires that the Commission’s “reasoned opinion” of non-compliance be brought to the Court.

- (iii) if a competent authority does not comply with the decision and the decision relates to a requirement that is directly applicable, ESMA may adopt a decision addressed directly to a financial market participant. We note, therefore, that ESMA cannot compel the competent authority to act.²¹

4.11 We do not see how Article 10 emergency measures could be applied in relation to securities regulation. We suggest therefore that the scope of the actions that might be required under Article 10 should be specified more clearly and should not include areas of securities regulation.²²

9 November 2009

THE CITY OF LONDON LAW SOCIETY COMPANY LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

William Underhill (Slaughter and May) (Chairman)
 Richard Brown (Lovells)
 Mark Curtis (Simmons & Simmons)
 Lucy Fergusson (Linklaters)
 Simon Griffiths (Addleshaw Goddard)
 Michael Hatchard (Skadden Arps)
 Nicholas Holmes (Ashurst)
 Simon Jay (Cleary Gottlieb Steen & Hamilton LLP)
 Eileen Kelliher (Allen & Overy LLP)
 Vanessa Knapp (Freshfields Bruckhaus Deringer)
 Tim Lewis (Macfarlanes LLP)
 James Palmer (Herbert Smith LLP)
 Christopher Pearson (Norton Rose)
 David Pudge (Clifford Chance LLP)
 Richard Spedding (Travers Smith LLP)
 Victoria Younghusband (SJ Berwin)

APPENDIX

Note: (1) The actions in italics have already been the subject of EC implementing measures.

(2) The sections in bold are expressly referred to in the proposed Directive which would amend MAD, the Transparency Directive and the Prospectus Directive and give ESMA express authority to make draft technical standards in these areas.

The technical standards may relate to:

(i) MAD

- The definitions of *inside information*, *market manipulation* and financial instruments (Article 1(1), 1(2), and 1(3));
- *The requirements for disclosure of inside information (Article 6(1) and 6(3));*
- *The requirements for delaying disclosure of inside information (Article 6(2));*
- The requirements for informing a competent authority of a decision to delay disclosure (Article 6(2));
- *The conditions under which issuers must draw up an insider list and the conditions under which they must be updated (Article 6(3));*
- *The categories of person who are subject to a duty of disclosure as persons discharging managerial responsibilities or those closely associated with them, and the triggers for their disclosure requirements (Article 6(4));*
- *The notification requirements of professional persons arranging a financial transaction who suspect insider dealing or market manipulation (Article 6(9));*

²¹ It would be ultra vires if the Regulation purported to provide such a power. This is recognised by the express reference to the powers of the Commission under Article 226 EC Treaty.

²² It is suggested in the Impact Assessment (paragraph 6.1.1.5) that this power could have been used to impose an EEA-wide short-selling ban but we do not believe that would be possible without additional primary legislation (see paragraph 60 of the CESR Consultation Paper on its Proposal for a Pan-European Short Selling Disclosure Regime CESR/09-581, July 2009) which would have to be in a form that was directly applicable for it to be within the scope of Article 10.

- **The procedures for exchange of information between competent authorities and for cross border inspections (Article 16(5)).**²³

(ii) Transparency Directive

- The definitions in Article 2(1), and *in particular procedural arrangements by which an issuer may choose its home Member State under Article 2(1)(i)(ii)*;
- An indicative list of means which are not be considered as electronic means (Article 2(1)(l));
- The requirements for publication of the annual financial report, in particular the conditions under which it is to remain available to the public (Article 4(1));
- *The requirements for publication of the half yearly financial report*, in particular the conditions under which it is to remain available to the public, the auditor's review, *and the minimum content of a condensed balance sheet which is not prepared in accordance with international accounting standards (Article 5(1)–(5))*;
- The requirements for the notification of the acquisition or disposal of major shareholdings *and the market maker exemption*, in particular the length of the “short settlement cycle” (Article 9(2), 9(4), 9(5));
- *The procedures for the notification of the acquisition or disposal of a major shareholding, including the management company and investment firm exemptions*, and **in particular the adoption of a standard form when notifying the issuer or when the issuer files with the competent authority and relevant timings** (Article 12(1), 12(2), 12(4), 12(5), 12(6), a new **12(9)**);
- *The types of financial instruments and agreements which will apply rise to calculating a major shareholding notification*, the contents of the notification, the notification period and the recipient of the notification (Article 13(1)). **A new article 13(3) proposes a standard form when notifying to the issuer under article 13(1) and when issuers file with the competent authority.**
- The notification requirements when a company purchases its own shares (Article 14(1));
- The procedures for making information available to shareholders for issuers whose shares are admitted to trading on a regulated market (Article 17(1)–(3));
- The procedures for making information available to debt holders for issuers whose debt securities are admitted to trading on a regulated market (Article 18(1)–(4));
- The procedures for issuers filing regulated information with the competent authority, in particular with regard to filing by electronic means (Article 19(1)–(3)).
- *The standards for the manner of disseminating regulated information*, and in particular for the central storage mechanism (Article 21(1)–(3));
- The information requirements for issuers whose registered office is in a third country, in particular ensuring the equivalence of information (Article 23(1), 23(2), 23(6)).

(iii) Prospectus Directive

- The definitions in Article 2(1);
- The exemption from the obligation to publish a prospectus for securities offered, or admitted to trading, in connection with a takeover or merger, in particular the requirement of “equivalence” in the takeover document (Article 4(1)(b)–(c) and 4(2)(c)–(d));
- *The format of the prospectus or base prospectus and supplements (Article 5)*;
- *The specific information to be included in a prospectus (Article 7)*;
- **The conditions for the authorised omission of information from a prospectus (Article 8(2))**;
- *The method of disclosure of a document referring to all information that an issuer has published over the preceding year in accordance with securities regulations (Article 10(1))*;
- *The requirements for incorporating information into a prospectus by reference (Article 11(3))*;
- The time limits for approval of the prospectus (Article 13);
- *The manner of making the prospectus public (Article 14(1)–(4))*;
- *The dissemination of advertisements announcing an intention to offer securities to the public or their admission to trading on a regulated market (Article 15)*;
- The requirements for a third country to ensure the equivalence of prospectuses by reason of its national law or international standards (Article 20).

²³ The sections in bold are expressly referred to in the proposed Directive which would amend MAD, the Transparency Directive and the Prospectus Directive and give ESMA express authority to make draft technical standards in these areas.

It is also proposed in the draft Directive to authorise ESMA to make technical standards:

- to determine the conditions of the obligation to provide a supplement to the prospectus under a new article 16(3);
- to determine the conditions relating to the procedures for the notification to ESMA of the certificate of approval, the copy of the prospectus, the translation of the summary and any supplement to the prospectus under a new article 18(4);
- to determine the conditions of cooperation and exchange of information between competent authorities, including the development of standard forms or templates for such cooperation and exchange of information under a new article 22(4).

Written evidence submitted by Marica Frangakis, Nicos Poulantzas Institute and John Grahl, Middlesex University Business School²⁴

FINANCIAL INSTABILITY: IS MORE EUROPE THE SOLUTION?

Summary

This submission does not examine the new European proposals in detail. Rather, it examines the record of the EU in general and the European Commission in particular in the field of finance. It argues that the record is one of disastrous neglect of stability and other public goods. The Lisbon Agenda itself and the main financial policy associated with it—the Financial Services Action Plan—completely ignored all aspects of finance except transactions costs. The Commission’s financial integration strategy worked to undermine every form of social control at both the member state and the European levels. Proposals to transfer regulatory powers over the financial sphere should therefore be treated with the greatest reserve unless and until there is evidence of a real change in the economic thinking of EU leaderships.

1. THE DE LAROSIÈRE REPORT IN CONTEXT

The pursuit of a single, financial market in the EU dates from the 1980s and the institution of the Single Market project. At that time, a number of directives were adopted, relating especially to the banking sector. The main obstacle to the integration of the EU financial services sector was however the lack of a single currency, which was not introduced until the early 2000s. In 1999 the Euro was officially introduced initially across 11 member states, soon spreading to encompass 16 out of the 27 member states of the EU today.

As the single currency project approached realisation, the issue of financial integration came to the forefront of economic policy considerations. An ambitious plan, the Financial Services Action Plan, was agreed upon, aiming at establishing the legal and policy framework for the deepening of financial integration across the EU over a relatively short period of time, namely 1999–2005. The completion of the Plan on time was indeed an achievement from the point of view of the administrative and the decision-making process, pointing to the political expediency of the exercise. However, the asymmetry between integration, on the one hand, and stability and consumer protection, on the other, implicit in the FSAP, was disregarded by the European Council and the European Commission.

The FSAP was followed by the Financial Services Policy 2005–10. This was mainly concerned with promoting integration in the retail sector, which remained relatively fragmented.

The preoccupation of the EU institutions with financial integration was abruptly interrupted by the current financial crisis. In the autumn of 2008, the full impact of the crisis was realised and a number of urgent measures were decided, while a group of high-level experts—the de Larosièrè Group—was convened, with the urgent mandate of submitting a report on the financial crisis and what to do about it. The relevant Report was submitted in February 2009, while the European Commission is pushing through a variety of measures, aiming at remedying at least some of the excesses of the past.

Two questions arise: the first is, “to what extent was EU policy responsible for the crisis?” The second question is “has the EU got it right this time?” Radical though some of the new measures may be by EU standards, can they be relied upon to produce a more stable, socially responsible and democratically accountable financial system? In view of the amount of taxpayer funding used to support the failing financial institutions across the EU, this question is central to the public debate today.

²⁴ On behalf of the Euromemorandum Group (European Economists for an Alternative Economic Policy in Europe): The EuroMemorandum Group consists of economists from many European Union member countries who take a highly critical view of the EU’s economic policies. Current policies restrict employment and abandon social control to unregulated markets. The Group argue for different policies with different priorities: to move towards full employment, to promote social justice and to protect the environment. Each year, the group holds a conference which jointly produces a memorandum assessing the current economic policies of the EU, and making the case for an alternative approach. The memorandum for 2008 can be downloaded from the Lawrence and Wishart website: <http://www.lwbooks.co.uk/ebooks/euromemorandum.html> The memorandum for 2009 is currently being prepared.

2. THE NEW REGULATORY AGENDA

The central agenda proposed in the de Larosière report reflects an emerging consensus on the nature of the reforms needed to render the banking system more stable. Important items in this agenda include:

- (i) *Macro-prudential supervision*—Completely neglected until now, it is going to be the responsibility of a European body. The de Larosière Report (LR) has recommended that a European Systemic Risk Council be set up, consisting of the EU central bankers, the chairs of the Level 3 Committees and the ECB President and Vice President, under the auspices of the ECB.
- (ii) *Micro-prudential supervision*—A new architecture is envisaged. The LR has recommended that a network of European financial supervisors—the European System of Financial Supervision—be set up, operating on the basis of harmonized rules and high quality information.
- (iii) *Regulatory framework*—The Commission is to submit proposals pertaining to the following areas: hedge funds and private equity (previously unregulated); tools for early intervention; increasing transparency for derivatives; increasing the quality and quantity of prudential capital for trading book activities and complex securitization.
- (iv) *Consumer/investor issues*—Measures include the strengthening of the effectiveness of marketing safeguards for retail investment products; reinforcing bank depositors; investor and insurance policy holder protection; “responsible lending”.
- (v) *Corporate governance*—Remuneration schemes in the financial services sector are to be brought within the scope of prudential oversight.
- (vi) *Sanctions against market wrongdoing*—Strengthening sanctions in a harmonized manner; review of the Market Abuse Directive.

Two further policy initiatives, which preceded the publication of the de Larosière report, need to be mentioned: (a) the revision of the Capital Requirements Directive (CRD) and (b) a new regulation concerning the issuance of credit ratings used in the EU.

The CRD comprises two Directives 2006/48/EC and 2006/49/EC, which adapted the Basel II framework to Community law, coming into effect in 2008. At its July 2009 meeting, the European Council adopted a directive updating the capital requirements for banks in the following areas:

- Large exposures—Banks to be restricted in lending to a single party beyond the limit of 25% of their own funds;
- Supervision of cross-border groups—“Colleges of supervisors” to operate in multiple EU countries, aiming at resolving home-host issues;
- EU-wide criteria for assessing whether “hybrid” capital, consisting of equity and debt, can be considered as part of a bank’s overall capital;
- Liquidity risk management rules—Setting up liquid asset reserves, conducting liquidity stress tests and establishing contingency plans;
- Securitisation practices—Originators to retain on their balance sheets 5% of risks transferred or sold to investors. Due diligence and transparency obligations to be strengthened, so that investors are able to assess the risks involved in structured products otherwise than solely by means of the ratings given by agencies.

As opposed to the revision of the CRD, which is a relatively recent development, the question of credit ratings and of the credit rating agencies (CRA) issuing them was raised for the first time in 2004. In particular, in response to a European Parliament resolution in February 2004 after the ENRON and PARMALAT scandals, the Committee of European Securities Regulators (CESR) was asked to suggest possible ways of supervising CRAs. The CESR however concluded that there was no need for formal regulation. The issue came up again in 2007, at the start of the current financial crisis. Finally, at its July 2009 meeting, the European Council adopted a regulation introducing a legal framework for credit rating agencies, which provides for a legally-binding registration and surveillance system.

Lastly, an important corollary of the attempt to strengthen regulatory processes is a drive to limit the possibilities for evasion and avoidance of regulation through the use of off-shore financial centres. The drastic budgetary weakening of all Western governments as a consequence of the crisis provides a second, fiscal, motive for much tighter restrictions on the use of these centres.

This agenda, in many respects common to the EU and to other international and governmental organisations, is a necessary response to the serious malfunctions within the financial system already detected by many critical commentators and now cruelly illuminated by the crisis. There are obviously many technical issues to be addressed within the reform programme; although the point is often made for apologetic reasons, it is true that regulatory restrictions can sometimes have unintended, and undesirable, consequences.

It is also necessary to view regulation as a dynamic problem, especially as regards the interaction of regulation and financial innovation. To avoid this interaction gradually undermining control, it will be necessary to change the balance of power between financial corporations and the regulatory authorities in favour of the latter—so that they can examine new financial practices, instruments and institutions and either require changes in, or completely suppress, those which endanger the integrity or stability of the financial system.

There will clearly be resistance to the reform programme and attempts to minimise its content and its consequences. This is both because powerful interest groups will be affected and because changes to the present role and status of the financial system involve a challenge to recently prevalent political and economic doctrines.

The present submission does not examine these regulatory reform proposals in detail. Rather it considers some of the issues raised by the political dimension of the report which argues that an important reinforcement of the role and powers of the European Union is the best way to implement the necessary reforms.

3. IS MORE EUROPE THE SOLUTION?

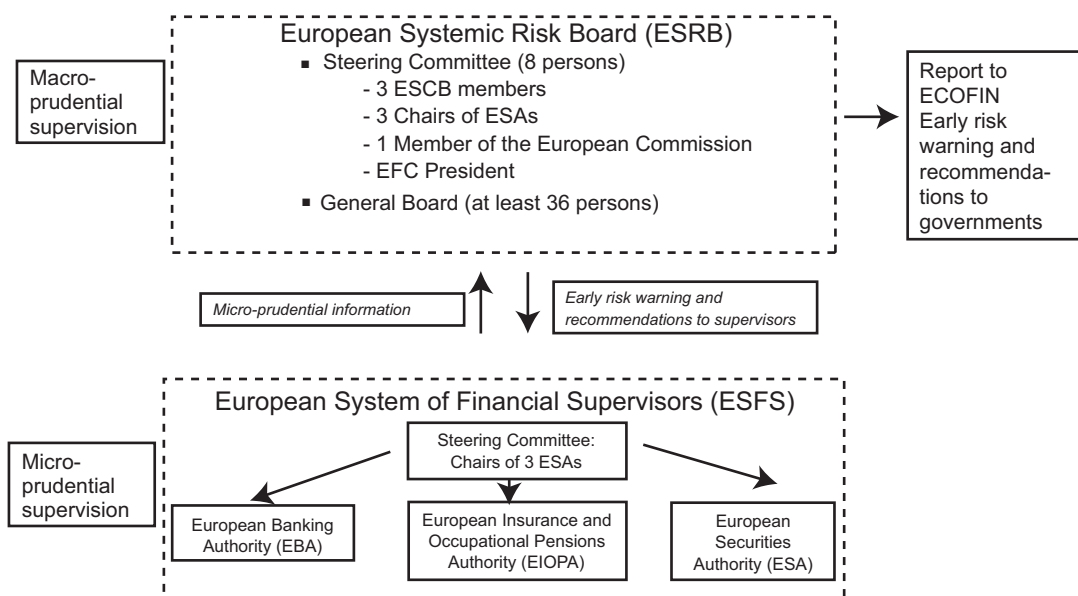
In the context of both monetary unification and its recent financial integration programme, certain EU-level regulatory bodies have been introduced. In relation to the ECB there are consultative bodies to pool information and coordinate policy responses on threats to financial stability. In the context of the financial integration process, after major difficulties were addressed in the Lamfalussy report, a series of committees were established whose main functions are to advance the harmonisation of regulatory rules and to secure their homogeneous implementation. In both cases, competence is very largely in the hands of the member states: the ECB does not have responsibility for financial stability; and, although its competition rules give the EU competence in certain aspects of financial regulation, in practice a broad consensus among member state regulators has been sought as the basis for regulatory harmonisation in the financial sphere.

De Larosière proposes a very significant reinforcement of central, EU level, authority in the financial sphere. The decisions taken by the European Finance Ministers on 9 June 2009 and subsequently adopted by the European Council on 18–19 June, broadly implement these proposals. From 2010 onwards a new structure should be in place to ensure more integrated European macro and micro prudential oversight.

- As regards macro-level supervision, a European Systemic Risk Council is to be set up. This is consultative in nature and it will function within the context of the European System of Central Banks, “under the auspices and with the logistical support of the ECB.” It will have broad powers to investigate and, through Ecofin, to challenge financial developments in the member states, including those not participating in the monetary union.
- As regards micro-supervision, the existing “level three” sectoral committees, which work on the harmonisation of regulation and supervision, are to be upgraded into supervisory Authorities, constituting a European System of Financial Supervision. This would retain the existing division of supervisory functions into banking, insurance and security trading sections, but would function in a more unified way. In particular, it would establish “colleges” of supervisors to deal with all those large financial corporations whose activities significantly affect more than one member state. Cooperation and information sharing within these new structures would be intensified and underpinned by legislation and disputes among member state regulators would be subject to binding resolution by the Authorities.

The structure and composition of the new supervisory framework is shown below.

The new European Supervisory Structure



Source: Lannoo, K, 2009, The road ahead after de Larosi re, CEPS Policy Brief No 195, August 2009.

These two significantly strengthened supervisory institutions would watch over the implementation of a much more homogeneous set of rules, which would, in particular lay down procedures for cooperation in dealing with financial problems affecting more than one member state. The simplistic formula of “home country control” would be modified in several respects to give greater protection to the host countries where banks and other financial corporations operate.

Clearly, the report suggests that further European integration is the correct framework within which to pursue financial reform. In one sense, it might also promise a more balanced pattern of integration in that the agenda it lays out is very much one of market correction as against the previously complete priority given to market creation.

A more specific value in the text is that it retreats from the EU’s previous hostility to “gold-plating” in the financial sphere—that is, it generally encourages rather than deprecates the introduction by member states of regulatory standards higher than those promulgated by the EU. Such higher standards are normally permitted in other spheres such as consumer protection, employment regulation and environmental protection. They perhaps slow down the integration process to some extent, but they ensure that when integration does take place it is at a high level. The recent attempt to weaken this principle, in the financial sphere and more widely, is yet one more example of the EU putting market integration ahead of other social and environmental objectives. Thus the move back towards the principle that there are no maximum standards in the EU is welcome.

Nevertheless, the notion that more integration is the key to financial reform also presents certain difficulties, some of which are addressed in the following notes. Firstly, the question of EU responsibility for the crisis is raised. Then, it is suggested that stability is not the only public good which has been neglected in previous EU financial policies. It is pointed out next that the prevailing macroeconomic imbalances in the eurozone aggravate financial problems. There is then a characterisation of the philosophy which has guided prevailing views of finance in the EU and elsewhere. A view is expressed on the continuing absence of Britain from the monetary union, which separates the eurozone from the EU’s biggest and most liquid financial markets. It is argued in conclusion that a financial sector motivated predominantly by the pursuit of profit is incompatible both with democratic values and with those of the European social models.

4. FINANCE AND THE LISBON STRATEGY

The global financial system which moved into crisis in 2007 is centred on the US and can in important respects be regarded as a projection of US financial structures and practices onto the world scene. This consideration does not absolve EU leaderships of responsibility. The role of the ECB will not be discussed here—it seems at least to have responded promptly to the emergency although it is to be hoped that it is not now preparing to “fire the interest rate trigger at the first sign of the inflationary fairy”, as feared by Wolfgang M nchau of the *Financial Times*.

The role of the Council and the Commission (and, especially, of D.-G. Internal Market), on the other hand, must be open to question. In the context of the Lisbon strategy, these leaderships have promoted a financial integration programme focused explicitly and exclusively on the reduction of transactions costs, on making the EU a very cheap place to do business. We have the testimony of no less a figure than Alexandre Lamfalussy that, in this drive, dangers to stability were deliberately downplayed. The climate in which the Lisbon programme was adopted was almost one of moral panic: the US was striding ahead towards the information society and a drastic liberalisation of European finance was a necessary condition for an effective response. The exaggeration of the EU's openness and of its exposure to external challenges has been a recurring theme in the retreat from ambitious internal objectives in the EU.

Alexandre Lamfalussy (former Director-General of BIS) was called in by the Commission to deal with serious problems in the process of financial integration

Lamfalussy draft report . . . “greater efficiency does not necessarily go hand in hand with enhanced stability . . . Increased integration of securities markets entails more interconnection between financial intermediaries on a cross-border basis, increasing their exposure to common shocks . . . there is an urgent need to strengthen cooperation at the European level between financial market regulators and the institutions in charge of micro and macro prudential regulation.”

Response of Commission:

“It was politely but firmly suggested that we drop the subject.”

Source: A Lamfalussy, *Creating an Integrated European Market for Financial Services*, in Philip Booth and David Currie (eds) *The Regulation of Financial Markets*, IEA, London.

Subsequent events were to show that cheap business may not always be good business. Eurozone banks in particular built up huge exposures to the US subprime fiasco (German hedge funds were among the earliest victims of the collapse), with leverage ratios substantially and consistently higher than those of US banks themselves, as shown in the table below.

KEY FINANCIAL INDICATORS OF THE TOP FIVE
BANKS IN THE EU AND IN THE USA IN 2007 (%)

	<i>Assets/GDP</i>	<i>Loans/Deposits</i>	<i>Equity/assets</i>
Belgium	463	104	4
France	293	101	3.5
Germany	165	94	2.6
Ireland	404	197	3.6
Spain	184	250	7.2
UK	313	125	3.9
EU27	237	133	4.3
USA	44	91	7.6

Source: Lannoo, K, 2008, *Concrete steps towards more integrated financial oversight—The EU's policy response to the crisis*, CEPS Task Force Report, 2008.

For the EU leaderships now to suggest that a transfer of powers to EU level is the appropriate solution to financial stability may be somewhat premature. It might be necessary first to demonstrate to citizens and member states that there has been a real and lasting change in the policies and priorities of the EU. It is hard to believe in such a change when the Commission President has just been reappointed by the EP on a minimalist programme of defending the internal market and little else.

Huge Leverage of European Banks

A press release from D.-G. Internal Market and Services (27 February 2008) asserts that European banks are well capitalised: “The origin of the current financial turmoil came from the US subprime mortgage sector and a large portion of the European financial sector is not directly affected by the turmoil at this stage. Where financial institutions have sizeable direct exposures to the US subprime market, or indirect exposures through structured products, the affected entities have well diversified portfolios and large capital buffers.”

This is simply not the case. Daniel Gros and Stefano Micosi report that, “the dozen largest European banks have now on average an overall leverage ratio (shareholder equity to total assets) of 35, compared to less than 20 for the largest US banks.” These economists recognise that the leverage numbers reported to regulators are much lower, but they explain this by the “massive in-house investment banking operations of European banks” which “are not subject to any regulatory capital requirement.” They give the following figures for the leverage ratios of European banks as of 30th June 2008: UBS, 46.9; ING 48.8; Barclays, 61.3; Crédit Agricole, 40.4, Deutsche (2007) 52.5. (Gros & Micosi, www.voxeu.org).

This exceptionally high leverage translates into particularly high exposures to “toxic” assets. Walter Munchau of the *Financial Times*, reacting to a recent IMF stability report, emphasised both the scale of these exposures and the fact that they had still not been written down by the banks concerned:

The most shocking news from last week’s excellent Global Financial Stability Report from the International Monetary Fund was not the headline estimate of total bad assets. That number stands at \$4,100 billion (£2,800 billion, €3,000 billion) and will almost certainly be revised upwards. Much more shocking was that the lion’s share of these assets belong to European, not North American, banks. Of the total \$4,100 billion, the global banking system accounts for \$2,800 billion. Of that, a little over half—\$1,426 billion—is sitting in European banks, while US banks account for only \$1,050 billion.

Even worse, European banks have written down much less than American ones. According to Reuters, the US and European banking and insurance sector has so far written down \$740 billion. More than 70% of the write-downs come from the US. The eurozone’s share has been an appalling 14%.

Another statistic from the IMF report: to recapitalise the banking system to reach capital ratios that prevailed in the mid-1990s, capital injections of \$275 billion would be required for US banks, and a whopping \$500 billion for European banks.

You get the picture. All these data tell us that Europe has both the biggest problem and has made the least progress.

Financial Times, 26 April 2009

5. MORTGAGES—AN EMBARRASSING SUGGESTION

Although the originate and distribute model of mortgage finance was, fortunately, never developed in the EU to the same extent as in the US, this was in spite of, not because of, Commission policy.

In fact, the shallow and mechanical approach to financial policy in the Commission is well illustrated by its abortive initiative on mortgages. When the legislative programme designed primarily to integrate wholesale securities markets was virtually complete, D.-G. Internal Market began to look for new market integration projects. It decided to press for integration of the mortgage market (Green Paper: *mortgage credit in the EU*, COM (2005) 327).

American practice was in the background here. One example was the view that with improved “risk assessment”, the risk capital required in the mortgage sector could be reduced (p11). Another was the belief that a big secondary market in mortgages was the way forward: “Many . . . express the view that the further integration of the EU mortgage markets could be considerably enhanced by the emergence of a pan-European funding market” (p13). There is no hint in this document that a continent-wide secondary market in mortgages might pose certain informational difficulties and the word, “stability” does not appear in the Green Paper.

The usual tame contract economists were hired to give their blessing to this fatuous proposal. Their report (London Economics, *The Costs and Benefits of Integration of EU Mortgage Markets*, August 2005) sang the praises of the US system, including its sub-prime component: “US experience suggests that:

- Legal or other restrictions to banks’ geographical expansions will reduce the efficiency of the mortgage-lending industry.
- Steps to create a single EU mortgage market would increase incentives to develop automated systems to process loan applications, which would reduce origination costs.
- Removing restrictions on maximum mortgage interest rates would *allow a subprime mortgage market to develop*, thus expanding total mortgage lending.” (p168, emphasis added).

The proposal would necessarily have led to the dismantling of the complex systems of social control which applied to housing finance at member state level: interest rate ceilings, maximum loan to value ratios, minimum income to loan ratios and so on—all would be swept aside. Nor was there any intention to imitate the US system of social control through the construction of powerful quasi-public corporations such as Fannie Mae. As late as February 2007, the mortgage proposal was still being promoted, but by the time of the *White Paper: on the Integration of EU Mortgage Credit Markets* (COM (2007) 807) at the end of the year there were signs of a reappraisal. The White Paper made the breath-taking assertion that “recent events in global mortgage markets have confirmed the pertinence of the approach proposed” (p 10). Of course, the opposite is the truth—the whole D.-G. Internal Market argument was based on the supposed desirability of more product “diversity” although product diversity was a key factor making US mortgage-backed securities opaque and risky.

In 2008, the theme of mortgage market integration has been quietly dropped—one has to look very hard to find it on the Commission’s web-site.

Meanwhile, Ireland, Spain and Britain were demonstrating the real consequences of deregulated housing finance with enormous asset price bubbles which have since burst, compromising financial stability, employment security and housing provision all at the same time.

6. FINANCE AND OTHER PUBLIC GOODS

Financial stability is an exceptional public good in that it enjoys widespread recognition from corporate and political elites who are often reluctant to accept that market processes should be corrected for other reasons. Toporowski, however, points out that the pursuit of financial stability is often at the expense of economic stability and, especially, of employment security. This is certainly the case at present as a huge deleveraging by the financial sector puts serious contractionary pressures on the rest of the economy. The indispensable measures taken by governments to counteract these pressures are, in turn, weakening public sector budgets (Jan Toporowski, “Enforced indebtedness and capital adequacy requirements”, Policy Note 2009/7, The Levy Economics Institute of Bard College, 2009).

The same elites who so are so quick to perceive the need for financial stability are preparing a veritable bonfire of other public goods, of tax-financed transfers and of public services in the name of budgetary rectitude. It would surely be contrary to the public interest to reinforce the EU’s financial powers while there is no explicit recognition of these public goods.

One example is social justice: the de Larosi re report comments on remuneration:

“The crisis has launched a debate on remuneration in the financial services industry. There are two dimensions to this problem: one is the often excessive level of remuneration in the financial sector; the other one is the structure of this remuneration, notably the fact that they induce too high risk-taking and encourage short-termism to the detriment of long-term performance. Social-political dissatisfaction has tended recently to focus, for understandable reasons, on the former. However, it is primarily the latter issue which has had an adverse impact on risk management and has thereby contributed to the crisis. It is therefore on the structure of remuneration that policy-makers should concentrate reforms going forward.”

This is a complete *non-sequitur*: policy-makers should “therefore” concentrate on the structure, rather than the scale, of payments only if they are indifferent to the “social-political dissatisfaction” provoked by their economic policies. It is true of course that such indifference has marked the decision-making of the EU, and in particular of D.-G. Internal Market, for some time. In particular, the Commission has waged a long battle to restrict and narrow the recognition of the public interest in order to maximise the reach of its competition strategies.

Such an indifference to the question of the level of remuneration is also displayed by the “Declaration of further steps to strengthen the financial system” issued by the G20 finance ministers and central bank heads meeting on 4 September 2009, in preparation for the G20 meeting on 24–25 September. Accordingly, such steps include the following:

- Greater disclosure and transparency of the level and structure of remuneration for those whose actions have a material impact on risk taking;
- Global standards on pay structure;
- Corporate governance reforms to ensure appropriate board oversight of compensation and risk.

Another public good neglected in EU financial policies has been consumer protection. Not only have regulatory consumer protections been consistently subordinated to the integration drive; the entire Financial Services Action Plan can be regarded as promoting a race to the bottom in the quality of financial services offered to the household because it tended to assimilate the financial systems of other member states to that of Britain, where security trading was highly developed. In recent years there have been a series of quite devastating critiques (several of them from the Treasury Select Committee) of retail finance in Britain, where the interests of the households have been consistently neglected and even traduced by banks, insurance companies and other financial agents.

Other public goods are of course at stake in financial reform: more equitable and democratic employment relations; environmental protection; the promotion of economic development and social security both in the weaker economies of the EU and beyond. Since the stabilisation of the financial sector alone, without changes in its goals and its functioning, would do little to advance such objectives, the de Larosi re proposals and their implementation by the EU so far must be seen as inadequate. It might be preferable to retain the maximum possible competence for financial reform in the member states until there has been a genuine enhancement of the EU’s aims and objectives.

7. FINANCIAL STABILISATION AND MACROECONOMIC IMBALANCES

Both at the global level and within the EU, there are important links between financial destabilisation and macroeconomic imbalances. Clearly, the US deficit was a conditioning factor in the subprime bubble in several respects. Comparable effects, however, can be found within the EU. Although the eurozone as a whole is close to balance on its current account, several of the weaker countries have developed substantial deficits. Until very recently these have been financed via real estate bubbles, which gave rise, in appearance at least, to assets which could counter-balance the increasing external liabilities of the economies concerned. The bursting of these bubbles puts very great pressure on these countries to improve their competitiveness and correct their payments deficits over a relatively short time period, but the monetary union leaves them no means to do so except the simple compression of prices and wages. No mechanism of fiscal redistribution mitigates this pressure.

This massive design flaw in the monetary union (for Michel Aglietta it makes it a “false” monetary union) has been pointed out over the last twenty years. It did not initially give rise to problems because the exchange rates at which countries entered the monetary union were carefully chosen. They are now, however, out of line (this may well have been inevitable in the longer term even without house price bubbles) and a very painful correction has to be made by several of the weaker economies (Michel Aglietta and Laurent Berrebi, *Désordres dans le Capitalisme Mondial*, Paris 2007).

The compression of wages and incomes might, under more favourable conditions, be brought about through low rates of inflation. German budgetary policies rule this out and make actual deflation unavoidable. In principle, inflation in the eurozone is meant to be near but less than 2%. Most eurozone members are quite close to this target, but Germany, which has by far the largest and most powerful economy, has consistently and deliberately undershot the target. For its eurozone trading partners, the consequence has been continuous contractionary and competitive pressure.

Again the absence of any coordinated or centralised budgetary policy was identified as a key weakness of the monetary union long before the euro was actually launched. The so-called Stability and Growth Pact was never a feasible replacement for such a common budgetary position—rather has it tended to drive the eurozone towards an extremely dysfunctional budgetary stance.

This is even more so at present, due to the fiscal impact of the financial rescue packages undertaken and funded by the EU countries, since there is no such thing as a “European Treasury”. According to the ECB, the cumulated interventions of the euro-zone countries are expected to increase the area’s government debt by 3.3% of GDP on average, while including the contingent liabilities implicit in the guarantees for interbank lending and new debt issued by the banks raises this to over 10% of GDP, excluding guarantees on retail deposits (ECB, “The impact of government support to the banking sector on euro area public finances”, *Monthly Bulletin*, July 2009).

The de Larosière report is silent on the institutional weaknesses of the European Monetary Union. However, a failure to put forward coherent proposals for the reform of the monetary union renders the programme of financial reform both dangerous and divisive. There would be every prospect that the recapitalisation and re-regulation of financial practices would have extremely asymmetric outcomes, with the weaker economies subjected to a much more intense and prolonged credit squeeze than those with stronger trade balances and competitive positions. This is particularly the case in Central and Eastern Europe, where practically all finance is provided by Western corporations.

Towards the end of 2008 the internal tensions in the eurozone were reflected in an alarming increase in the yield spreads on the government debt of the weaker economies (relative to rates in Germany). Such differences affect not only public finance: these yields act as benchmarks for the financial system as a whole. Vigorous action by the ECB has since narrowed the spreads. But there remain serious imbalances among the eurozone countries and no proposals for reforms to the macroeconomic regime which would permit these imbalances to be addressed in a coherent way. Thus, once again it seems undesirable to endorse the de Larosière proposals unless they are embedded in a much wider and more comprehensive programme of policy reform within the EU.

8. BRITAIN VERSUS THE EU?

The refusal of Britain to participate in the monetary union significantly weakens the latter and deprives it of political influence and economic effectiveness. Monetary policy works through its impact on banks and financial markets; the fact that the most important financial centre in the EU is outside the monetary union makes policy moves less effective. Differences in policy stance deprive the EU of its potential weight in international negotiations on financial reform. During 2007 and 2008 there were clearly divergent views in Frankfurt and London as to the best response to the deepening crisis. The first financial reform directive adopted in the EU, which aims at stricter control over hedge funds, has met with opposition from the British, concerned about the possible loss of financial business to other centres. Here, not for the first time, the British were much closer to the US position than that of their EU partners.

At present there are no efforts to bring Britain into the monetary union or to resolve the differences which nevertheless work to the disadvantage of both parties. There is a clear clash of interests in that the British fear that EU regulation might undermine the status of London as a financial centre. On the other hand an agreement which strengthened the financial status of the eurozone, and thereby strengthened Europe’s role in global finance would be to Britain’s advantage also. Sterling is a diminishing asset—it would be in Britain’s interest to negotiate entry into the eurozone today in return for substantial reforms in the monetary union, rather than be driven to adopt the euro in a future foreign exchange crisis, when such negotiations would not be possible.

If its internal tensions could be reduced, the eurozone would be ideally placed to contribute to a rebalancing of the global economy. An expansion of internal demand, very necessary in any case to respond to unemployment, would facilitate a correction of the US current account deficit and lower the costs of making that adjustment. Investors around the world would be very ready to finance such an expansion and a rigorous reform of EU financial institutions and practices would make them more so. The outcome would be a certain shift from dollar-denominated to euro-denominated finance and this would make entry into the

eurozone more attractive for Britain. At the same time such a shift would permit the EU to play a more active role in the reform of the international financial system. A closer alignment of British and European positions would further increase EU influence.

At present, political and economic leaderships in Britain are not prepared even to consider adopting the euro. The main problem is no longer divergence in economic developments between Britain and the rest of the EU but rather a macroeconomic regime which fails to meet general European priorities. Thus a negotiated entry of Britain into the monetary union together with a generally acceptable reform programme might be made to serve the interests of all concerned.

In any case, actual differences between Britain and its EU partners are so wide as to rule out a thorough and effective reform of the financial system. The de Larosière report fails to address these differences and this is a key political weakness in its approach.

9. CONCLUSION

The complex emergence of a global financial system has permitted elites with central positions in our banks, financial markets and large corporations to subordinate general economic priorities to their own narrow interests. In so doing they have expropriated vast sums of money from the ordinary citizens and business enterprises who have to make use of financial services. They have distorted the pattern of economic development and neglected the priorities of sustainability and social justice. Their mismanagement of investment and resource allocation has led to an immense crisis followed by the most damaging recession since the Second World War.

Clearly, reforms to render the financial system more stable are a necessary response to this state of affairs. Just as clearly they are not a sufficient response. Power without responsibility on this scale weakens democracy itself. Financial reforms must therefore only be one component of a much broader assertion of social control over the financial system.

The role of the EU in the necessary changes is open to debate. But if the EU merely advances a set of stabilisation proposals without reference to the social context and the need for political change, it will further undermine its relevance to the values and interests of European citizens.

13 November 2009

Written evidence submitted by Association for Financial Markets in Europe (AFME)²⁵

EXECUTIVE SUMMARY OF MAIN POINTS

1. Our main points are as follows:

- (a) EU macro- and micro-prudential arrangements should be integrated within and support, and not cut across or cut off, arrangements for cooperation and coordination at global level. It is particularly important to ensure that the European Supervisory Authorities' (ESAs') participation in EEA colleges, and provisions for information sharing in the EU, do not undermine or deter cooperation by third countries (paragraphs 5 to 8 and 17 below).
- (b) It is essential that the composition, internal structures, and resourcing of the ESAs ensure that they have clear scope, transparent processes, technical expertise, and independence (paragraph 10).
- (c) It is important to ensure that "binding technical standards" that are to be developed by the ESAs respect the technical/policy boundary, do not impinge on or inappropriately restrict the scope and application of supervisory judgements permitted by the sectoral Directives, are properly informed by consultation and impact analysis, and, since they would be subject to confirmation as EU Regulations by the European Commission (EC) without going through an EU political process, are controlled by appropriate checks and balances (paragraphs 12 to 15).
- (d) The proposed powers for ESAs to take decisions that are directly applicable to firms, and for the ESAs and European Systemic Risk Board (ESRB) to demand information directly from firms, must be limited to clearly defined emergency circumstances, and not cause legal uncertainty for firms (paragraphs 16 to 17).
- (e) The scope for properly considered scrutiny of EC's Proposals is limited by the rapid timetable and the staggering of both the issue of and negotiations on different proposals which have linked and interacting themes. It will be important to review the package as a whole, and make amendments where necessary, to ensure that as a whole it fits together and is appropriate (paragraph 22).

²⁵ AFME was formed on 1 November 2009 by the merger of the London Investment Banking Association (LIBA) with the European operations of the Securities Industry and Financial Markets Association (SIFMA).

AFME: A BRIEF INTRODUCTION

2. The Association for Financial Markets in Europe (AFME) was formed on 1 November 2009 by the merger of the London Investment Banking Association (LIBA) with the European operations of the Securities Industry and Financial Markets Association (SIFMA). AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. It communicates the industry standpoint on issues affecting the European, international, and UK capital markets to regulators, policy makers, and the general public.

3. LIBA, one of AFME's predecessor associations, provided written evidence on 30 April 2009 for the Treasury Committee's inquiry into the International Dimension of the Banking Crisis.

FACTUAL INFORMATION

The interaction between EU, national and international regulatory and supervisory arrangements.

4. The EU Proposals interact in important ways with major strands of the G20's and Financial Stability Board's programme to make targeted improvements to prudential rules at global level (through the Basel Committee), and to improve arrangements for global supervisory and financial stability cooperation, in particular through the effective operation of global colleges of supervisors. It is important that national and regional rules and coordination arrangements remain consistent with the agreed global approach, to avoid mismatches and incompatibilities.

5. EU arrangements, because they have a legal basis, have the capacity to contribute substantially to the consistency of regulatory requirements and supervisory approaches worldwide. It is important, however, particularly for groups whose headquarters are outside the EEA, that European arrangements integrate effectively with, support, and do not cut across, or cut off, arrangements for cooperation and coordination with third country supervisors, which are of necessity based on less binding legal arrangements, typically memoranda of understanding with third country authorities. The EU can and should play a leading role in the development of global policy, but it needs to ensure that where it leads, the rest of the world will come too.

6. The European Commission proposes close ESA involvement in, and control over, college activity within the EEA, including a central ESA role in information collection and dissemination. While a central role for ESAs in EEA colleges may help EEA supervisory coordination, in particular for EEA-headquartered firms, there is concern that, for firms that are headquartered outside the EEA, the supervisors in those countries are likely to require separate global colleges on the basis that, when they are supervisors of the parent of the group, they are unlikely to wish to be bound by rigid protocols set up by the EEA members of the college.

7. The willingness of supervisors outside the EEA to engage and share information through colleges, and therefore the quality of global supervisory cooperation and systemic risk management more generally, is likely to be harmed by too rigid and EU-centric an approach, and by any assumption that all information would be fully distributed to all EEA college members (see also paragraph 17 below). It is important to build into the legislation safeguards to ensure that information derived through global colleges from non-EEA supervisors cannot be automatically distributed unless the consent of the third country supervisor has been obtained. The existence of an Memorandum of Understanding (MOU) between relevant authorities should be an appropriate indication that the third country supervisor is satisfied that the relevant legal gateways for the passing of information are in place. If no MOU exists the sharing of firm specific information with other Member State authorities should be restricted only to information which is derived from EU activities.

8. It is vital to ensure that EEA college arrangements operate in as streamlined a way as possible with global arrangements, and EU requirements do not impair global supervisory cooperation, coordination, and information sharing.

The composition and internal structures of the supervisory authorities and the ESRB

9. The voting membership of the ESRB consists primarily of central banks. ESAs are present in a voting, and national supervisors in a non-voting capacity. Although changes are not needed to the proposed arrangements, given the close interaction between financial stability analysis and regulatory activities it is important that the ESRB takes due account of the opinions of national supervisory authorities.

10. Given their proposed functions and powers, it is essential that the composition, internal structures, and staff and resources of the ESAs are characterised by a clear scope, transparent processes, technical understanding and expertise, independence from national interests, and the need to have regard to proportionality, facilitation of innovation and competition, and maintaining the competitiveness of European financial markets.

Whether the powers proposed for these bodies are appropriate.

11. The proposed powers for ESAs to issue guidelines and recommendations are a continuation of the existing functions of the Level 3 Committees: these are appropriate powers, and an important means to promote supervisory convergence. The Proposals also provide appropriate mechanisms under which ESAs can support the EC's "Level 4" role of ensuring compliance with EU law.

12. Under the ESA Proposals and the “Omnibus” Proposal, EC proposes that in a closed list of “technical” (not “policy”) areas under sectoral Directives, the ESAs be given the power, and in some cases are instructed, to specify “binding technical standards”. These technical standards would be subject to confirmation, and potentially modification, by EC, without going through an EU political process, as EU Regulations or EC Decisions. It will be important to ensure, in the context of the “Omnibus” Proposal, that technical standards do indeed respect the “technical”/“policy” distinction, and in particular that they do not inappropriately constrain supervisory judgements by national authorities that are provided for in the sectoral Directives.

13. A thoroughly embedded consultation and impact assessment process is essential to help ensure that the distinction between technical detail and policy interpretation or development is observed. It is equally important to ensure appropriate checks and balances over the power of the ESAs to propose, and EC to endorse, the binding technical standards and in this specific context the potential power the EC may have to modify the ESAs’ proposals are a particular concern.

14. EC proposes a mechanism for ESAs to take “binding” decisions on: the consistent application of EU legislation; action in an emergency; and the settlement of disputes between national authorities. In these areas “binding” decisions would be ultimately referable to the ECJ as only the ECJ has the competence to rule definitively on breach of community law. EC also proposes that ESA decisions be binding on firms in relation to “directly applicable” EU Regulations. Although at present most EU law (including all prudential measures) is in a form which is not “directly applicable”, the proposed new “binding technical standards” (see paragraph 12 above) might well take this form.

15. Effective and consistent enforcement of EU law is an essential goal. But it is important that consistency is not pursued for its own sake, where doing so would prevent sensible supervisory judgements being made. Given that EC may turn technical standards into EU Regulations, and thus make them directly applicable to firms, it is important to ensure that in these cases the technical standards are proportionate and truly “technical” (in the sense of focusing on matters such as procedures, or consistent regulatory reporting), as described in paragraph 12 above, and avoid imposing a single prescriptive approach in matters where judgement is necessary and prescription inappropriate (for example, the supervisory assessment of the quality of internal risk-based models).

16. It is important to ensure that the procedures for binding decisions in relation to technical standards minimise any scope for delay, indecision, or conflict, especially in an emergency. Only in exceptional and carefully defined emergency circumstances should ESAs have the ability to override national authorities and apply decisions directly to firms.

17. EC proposes that both the ESRB and ESAs should, in certain circumstances, have the power to obtain firm-specific information directly from firms. It is right that the ESRB and ESAs should have access to the information that they need to perform their role. But despite the fact that the EC Proposals embody confidentiality obligations, the breadth of membership of the ESRB and ESAs, and the market sensitivity of certain information, is such that there is very great concern among firms that more stringent safeguards are needed to validate that firm-specific information does indeed need to be provided; in particular the firm itself should have the right to have its view heard on the appropriateness of an information request, and any firm-specific information should be channelled to the ESA or ESRB through the national authority, and not obtained directly. In this context, it is particularly important to be aware that third country authorities could be deterred from effective and open supervisory cooperation if they believed that the confidentiality of information provided to European supervisors through global colleges would not be respected.

The proposals’ effect on the competitiveness of the European financial industry in general and the City of London in particular

18. There is much in the ESRB and ESA Proposals that supports the competitiveness of the European and London financial industry, in particular:

- (a) The introduction of a structured process, through the ESRB, to identify and assess the implications of risks to financial stability, to provide for follow up of identified risks through a comply or explain process, and to link with global financial stability arrangements managed by the FSB and IMF;
- (b) The potential for streamlined compliance in cross-border groups as a result of greater alignment of technical standards;
- (c) The more formalised and effective structure for peer review, analysis of divergent implementation, and “Level 4” follow up of failures to implement directives properly;
- (d) The continuation of Level 3 Committee activities aimed at promoting supervisory convergence and coordination, and mediated settlement of disputes;
- (e) The provision for structured policy consultation with market participants.

19. Some aspects of the Proposals might make the conduct of financial services business from the EEA less attractive, and thus pose threats to Europe’s and London’s competitiveness. The following aspects will need to be carefully monitored as the political process unfolds:

- (a) The potential introduction of legal uncertainty, including the challenge to existing supervisory decisions made by the home state supervisor;
- (b) Provision for the direct supervision of firms by ESAs, currently in limited circumstances, but with the potential to become more wide-ranging if “technical standards” in the form of Regulations are developed;
- (c) Confidentiality concerns associated with the ESAs’ proposed ability to approach firms directly for information, and to distribute it to other bodies;
- (d) The potential for conflicting or duplicative demands to be placed on firms by any one of a range of national/EU authorities, currently in limited circumstances, but with the potential to apply more broadly;
- (e) More complex and ill-defined relationship with countries outside the EEA;
- (f) The absence of checks and balances on EC’s control over the content of “binding technical standards”
- (g) The weakness of provisions for ESA consultation with interested parties and impact assessment.

The timescale for agreeing the legislation

20. The European Commission (EC) made Proposals on 23 September 2009 for the EU Regulations to establish the ESRB and the three ESAs. It made a Proposal on 26 October for an “Omnibus Directive” amending sectoral directives, in particular the Capital Requirements Directive (CRD), to give effect to the powers of the ESAs in specified areas. A further Proposal for an “Omnibus 2 Directive”, making further sectoral amendments, is expected in early 2010.

21. We understand that the Council aims for political agreement on the ESRB Proposal by the end of December 2009, and on the ESAs and “Omnibus” Proposals by the end of March 2010. The European Parliament process is likely to take longer, perhaps until June 2010.

22. The rapid timetable is driven by the political commitment to have the ESRB and ESAs in operation by the end of 2010. It does however, particularly at a time when an unusually large number of policy proposals are under development in a range of areas in the wake of the financial turmoil, place great strain on the ability of policy-makers and interested parties to give the Proposals proper technical scrutiny. The time pressure is intensified by the fact that a series of Proposals whose content interlocks have been made, and are being scrutinised by the Council and European Parliament, on a staggered timetable.

Recommendations for action that we would like the Committee to consider including in its report

23. We suggest that the Committee consider including in its report recommendations along the lines of those we make in paragraph 1 above.

13 November 2009

Written evidence submitted by GC100

1. I write on behalf of GC100 in response to the Treasury Select Committee inquiry into proposals for strengthening financial supervision in Europe.

2. We note that the Committee published its report on this inquiry slightly earlier than expected and has concluded that reaching agreement on such an ambitious package in less than three months is overambitious. We would ask the Committee to take on board the points raised below in its future consideration of this matter and would welcome the opportunity to provide input moving forward.

3. As you may be aware, GC100 is the group for the general counsel and company secretaries in the FTSE 100. There are currently over 120 individual members of the group, representing some 80 issuers.

4. We are writing in respect of one aspect only of the proposals, namely the establishment of a European Securities and Markets Authority (ESMA).

5. We are supportive of the establishment of ESMA provided that it does not impose an additional layer of bureaucracy (at a time when the EU’s Better Regulation initiative is seeking to reduce the regulatory burden where appropriate) and that it does not impede the efficient operation of the securities markets. We would also stress that the securities markets are global markets. The UK market in particular has been effective in attracting international third country issuers. If the efficacy of that market is prejudiced, then issuers will simply opt to list and raise capital outside the EU which will be to the detriment of the EU as a whole.

6. We are concerned that there are inevitable differences in securities market regulation: years of careful focus and consideration have resulted in the current framework for securities regulation, which at the EU level is contained in the Prospectus Directive, the Transparency Obligations Directive and the Market Abuse Directive. Super-equivalent rules are permitted in a range of areas and the UK market has consistently (through the UK Listing Rules) been more heavily regulated than other markets, attracting capital to the UK.

7. In addition, given the scale of UK securities markets, the UK has exceptional experience of regulation in this area. We are concerned that requirements to regulate across each EU securities market will lead to less experienced and sophisticated regulation of UK securities markets, with no good reason being given for overturning the very carefully constructed current regime, itself the product of years of engagement between the EC and Member States.

8. The wider proposals on financial supervision have been made on the basis that a substantially common approach is to be taken to the establishment of the banking and insurance regulators (the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA)), but, for the reasons given below, we do not think that there should be a common approach to securities market regulation. We believe that:

- (a) The competitive position of the UK markets in the International arena stands to be damaged by the imposition of the ESMA as suggested.
- (b) The operation of Listed UK Plc will become more onerous under ESMA, threatening increased risk of corporate redomiciliations.
- (c) A common rule book and technical standards will not be achievable in all areas of securities and markets supervision and that the inclusion of this area in the proposals threatens the timely delivery of the main elements—the EBA and EIOPA.

9. It appears to us that regulation of securities laws (affecting all listed companies) is being changed in a way which matches changes to banking and insurance laws, as part of the reaction to the financial crisis. However, there is no evidence that we are aware of that securities market regulation has failed or been threatened or has in any way created systemic risk. On the contrary, at least in the UK market, securities regulation continued effectively throughout the financial crisis. We note that regulation of short selling is the one area of securities market regulation that arose in the financial crisis. However, we note that different issues existed in each market and that national regulators were able swiftly to move in a co-ordinated way, but in a way which allowed each to tailor its response to national market issues, as inevitably is required. We also note that academic research has been sceptical of the need even for this co-ordinated regulatory reaction.

10. In addition to covering the Prospectus Directive, the Market Abuse Directive and the Transparency Obligations Directive, the new regime provides that the Takeovers Directive is within the scope of ESMA's proposed authority. We cannot see why this should be, and indeed wonder if this is perhaps an oversight: the proposed objectives of further harmonisation are in direct conflict with the stated scope of the Takeovers Directive, carefully crafted after years of debate. Further, takeover regulation has nothing to do with the financial crisis. In the UK, the Takeover Panel is the takeover regulator. If it has to implement technical measures imposed by ESMA (the precise scope of which are not entirely clear), it seems there is a real risk that the Takeover Panel's highly effective current approach to regulation will disappear, without any real thought as to the justification for such a significant step.

11. Accordingly, it appears to us that, as part of the understandable reaction to the financial crisis and desire for thoughtful new regulation to address the weaknesses revealed, securities regulation has been brought into the regulatory response. EU principles of subsidiarity require regulation to be left at national level absent justification for EU regulation. We can see no such evidence here.

12. We have no concern about the establishment of the ESMA to take over the existing role of CESR, nor in relation to its advisory or information gathering roles, but we are concerned that in the hurry to respond to the financial crisis, insufficient thought has been given to the justification for ESMA being granted additional powers matching the powers of the EBA and EIOPA, which are financial industry regulators. ESMA should focus on EU rules and their consistent interpretation and application by national supervisory authorities, and in our view ESMA should not second guess or seek to override national supervisory judgements.

To summarise, we do not doubt that regulation at the EU level is appropriate in response to the financial crisis. However, we have serious reservations in relation to the proposals for European securities markets, which do not seem to be based on any evidence at all as to any current defect or weakness in existing securities market regulation, but rather seem to present risks of more remote regulation, which inevitably may cause problems and impact on market effectiveness. In addition we see no reason whatsoever for the inclusion of takeover regulation in the scope of ESMA's objectives.

Please note that the views expressed in this letter do not necessarily reflect those of each and every individual member of the GC100 or their employing companies.

18 November 2009

Written evidence submitted by the Quoted Companies Alliance (QCA)

INTRODUCTION

The Quoted Companies Alliance (QCA) is a not-for-profit membership organisation working for small and mid-cap quoted companies. Their individual market capitalisations tend to be below £500 million. The QCA is a founder member of EuropeanIssuers, which represents over 9,000 quoted companies in fourteen European countries. The QCA Legal Committee has examined your proposals and advised on this response and a list of Committee members is at Appendix A.

RESPONSE

The QCA is grateful for the opportunity to provide evidence on the European Commission's proposals for financial regulation and supervision, and in particular, on:

1. *The interaction between EU, national and international regulatory and supervisory arrangements*

Users of financial regulations, including companies who issue shares and other securities, require a significant level of clarity in the regulations to allow them to meet their legitimate commercial objectives, such as raising capital or debt funding. Any lack of clarity adds to the amount of time and resource it takes to achieve compliance and, ultimately, to the costs of doing business.

This is particularly true of smaller companies, of which there are many, which have limited resources.

At the end of October 2009 there were:

- 1,031 companies listed on the UK Official list, of which 628 had a market capitalisation of less than £250 million;
- 1,335 companies listed on AIM of which 1,041 had a market capitalisation of less than £50 million; and
- 183 companies quoted on PLUS markets with an average market capitalisation of approximately £12.5 million.

These companies employ millions of employees in the UK and contribute significant amounts of tax revenue through the collection of PAYE and National Insurance, VAT and corporation tax. In addition, as a result of trading in their shares, shareholders pay both stamp duty and capital gains tax. Securities issued by these companies also form the core element of the pension policies of millions more ordinary people. The indirect effects of lack of clarity affect huge sections of UK society. At present the EU Internal Market and Services Directorate General (DG MARKT) has responsibility for harmonisation of the regulation of financial regulation throughout the EU. Its flagship policy to provide a level playing field has been anchored on the introduction of four major EU directives each of which went through a lengthy gestation period:

- (a) *The Prospectus Directive*—a directive aimed at creating a common set of requirements to be met by companies making offers of transferable securities to the public throughout Europe. Companies complying with these requirements, whose documents are signed off by their home state regulators, can also use the prospectuses for public offers of securities in other Member States by registering those documents with the home state financial services regulator in the State that they intend to make such an offer. The Prospectus Directive came into force throughout the EU on 1 July 2005. It came into force in the UK on that day, and the UK home state regulator is the Financial Services Authority, acting through its division known as the UK Listing Authority or UKLA.
- (b) *The Market Abuse Directive* was intended to create a common set of rules throughout the EU dealing with insider dealing, market manipulation and the abuse of price sensitive information.
- (c) *The Transparency Directive* introduced common accounting standards for listed companies throughout the EU, settling on International Financial Reporting Standards (IFRS), and set up procedures to decide on the “equivalence” of other widely used accounting standards. It also affected financial reporting, reporting of shareholdings and corporate responsibility for financial information.
- (d) *The Markets in Financial Instrument Directive (MiFID)* was introduced to regulate the way financial services businesses transact business in securities, categorise clients, provide client protections and report trading in securities. This has affected listed companies through changes in the legal relationship between them and their sponsors/corporate advisers and fundamental changes in the regulation of investment research.

Each of these directives has affected UK financial services law and regulation.

These directives have all been brought into force in the UK through amendments to the Financial Services and Markets Act 2000, the Companies Act 2006 and through changes to and, in the case of MiFID, a wholesale re-write of the FSA Handbook. These four directives were brought into effect through a specific EU legislative process introduced in 2001 known as the Lamfalussy process. This process was supposed to strengthen the European regulatory and financial sector supervision framework by introducing a four level process. Level 1 starts with the adoption of framework legislation, while the detailed implementing measures (Level 2) are derived from technical advice received by the Commission from the three technical committees, made up of representatives of national supervisory bodies, in banking (CEBS), insurance and occupational pensions (CEIOPS) and the securities markets (CESR). In giving their advice, the Level 3 committees carry out their own consultations. It is the Level 2 implementing measures which are then incorporated into national law.

The Level 3 committees also have a brief to foster supervisory convergence and best practice. To this end, they plug some of the “gaps” in the legislation through the creation of guidance, which is, technically, not legally binding. However in the UK, so far as issuers are concerned, compliance with this guidance is enforced by the UKLA, which will not approve documents that do not comply fully with the relevant “guidance”.

At this stage, the technical committees are supposed to deal with teething problems by carrying out consultations and enquiries and recommending amendments to the legislation (Level 3). The Commission is then obliged to review the transposition of the legislation into national law and its operation (Level 4). The Commission can also pursue enforcement action where Member States are blatantly not complying with the legislation. Currently the FSA is an active participant in all three Level 3 committees and also provides technical input. FSA Chief Executive Hector Sants is the UK’s member of CESR.

The FSA’s published view is that the Level 3 committees, “while capable of improvement, offer the best prospect of achieving regulatory convergence in the EU”.²⁶ However, the Level 3 committees have, until now, operated with committees whose members generally have full time jobs elsewhere, and consequently, have relatively limited amounts of time a resource to spend full time on EU regulatory matters. However, CESR is not the only body to which the Commission turns when seeking advice on financial regulation. In 2006 DG Markt set up its own advisory committee, the European Securities Markets Expert Group (ESME), to look at specific issues arising in practice under the EU securities Directives and to propose changes. Technically this group was set up under the EU’s Better Regulation agenda and, as such, sits outside the Lamfalussy process. However its input and advice is quite persuasive in information gathering and opinion forming within the Commission. However, ESME is also a committee made up entirely of dedicated volunteers who have full time day jobs.

Other national regulatory bodies which play a significant role in the current financial regulatory regime in the UK include:

- (a) the Financial Reporting Council (FRC), which plays a dual role of supervising domestic accounting standards and policies, and providing and supervising the UK’s corporate governance regime for listed companies;
- (b) the Takeover Panel, which, following implementation of the EU Takeover Directive, now has a statutory basis on which to regulate and umpire public company takeovers;
- (c) the Department for Business, Innovation and Skills (BIS), which is responsible for company law reform, an area which constantly overlaps with financial regulation; and
- (d) HM Treasury, which broadly retains regulatory competence for the aspects of corporate regulation which have a fiscal impact.

As the UK’s membership of the Level 3 committees are currently focused through the FSA, these other players in the UK financial regulatory system appear to have less opportunity to directly impact the EU process. There is a sense that the relationship between FSA and CESR is guarded closely by FSA. The QCA has had a direct experience of this attitude during the Prospectus Directive’s implementation process in the first half of 2005. At that time, the FSA insisted on a particular interpretation of a provision of the directive that would have had a material impact on the ability of discretionary private client fund managers to participate in fund raisings by companies seeking admission to the AIM and PLUS markets. Following extensive lobbying efforts in conjunction with the Association of Private Client Investment Managers (APCIMS), HM Treasury introduced specific legislation into the Financial Services and Markets Act to clarify this point.

Internationally, the International Accounting Standards Board (IASB) has become the de facto standard-setter, following the adoption of the Transparency Directive. As a direct result of the adoption of the IASB’s IFRS as the official accounting standards for EU listed companies, the Commission has found itself stuck with the IASB’s views on accounting policy. In particular, the widespread move to “fair value” accounting with its “mark-to-market” requirements away from the long established “historic cost” basis of accounting has been partially credited for the accounting uncertainties, which contributed significantly to the turmoil of financial markets in September and October 2008.

²⁶ <http://www.fsa.gov.uk/Pages/About/What/International/european/lamfalussy/index.shtml>

2. *The composition and internal structures of the supervisory authorities and the ESRB*

The De Larosière report, published in February 2009, recommended that following the financial crisis Europe needs a new system of supervision and crisis management. Its proposals have been adopted by the Commission and firm proposals for EU legislation largely based on the findings of that report have now been proposed.²⁷

It is recommended that a new group replace the current Banking Supervision Committee of the European Central Bank, to be called the European Systemic Risk Board (ESRB). It should be set up under the auspices and with the logistical support of the ECB. Its task will be to form judgements and make recommendations on macro-prudential policy, issue risk warnings, compare observations on macro-economic and prudential developments and give direction on these issues.

The ESRB is proposed to be made up from the President of the ECB, the vice-president of the ECB and the Governors of the 27 Member State central banks, plus the Chairpersons of CEBS, CEIOPS and CESR and one representative of European Commission. The President of the ECB would chair the ESRB, and it would be supported by a secretariat provided by the ECB.

In order to interact closely with relevant supervisors who are not part of central banks, the Commission Communication of 27 May 2009²⁸ suggests that each central bank governor should be accompanied by one senior representative of their national supervisory authorities as an observer. The representative accompanying the central bank governor could vary from meeting to meeting, depending on the issues to be discussed by the ESRB.

The Commission has suggested that the ESRB Chairperson should be the ECB President with a Vice-Chairperson from among those Member States outside of the euro area.

In addition a smaller steering committee, leaving out the majority of the central bank members, is advocated. The ESRB would also have its own technical advisory committee.

De Larosière further proposed the establishment of a European System of Financial Supervision (ESFS)—an integrated network of European financial supervisors, working with the Level 3 committees whose powers will be enhanced so that they become European Supervisory Authorities (ESA), including: a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA).

The idea is that existing national regulators would continue with their day-to-day supervisory activities and retain much of what they currently do. But, primarily in order to supervise principally large cross-border institutions, which are thought to pose systemic risks, the ESAs will carry-out a certain tasks at an EU level.

While the home Member State regulator will continue as the first point of contact for a firm, the ESFS would coordinate the application of common high level supervisory standards, “guarantee strong cooperation with the other supervisors, and . . . guarantee that the interests of host supervisors are properly safeguarded”.²⁹

To implement these changes the new ESAs will need to have greater resources, more people and larger budgets while simultaneously becoming more pro-active in identifying problems and proposing solutions, developing peer review and mediation processes, and stepping up cooperation with each other.

Each ESA will have a full-time independent chair and an executive director appointed by the board, each for a 5 year term extendable once only and confirmed by the European Parliament.

The Board of Supervisors will be the main decision making body of the ESAs, comprising the Chair, the Head of the relevant national supervisory authority in each Member State, a representative of the Commission, a representative of the ESRB, a representative of each of the other two ESA's and relevant observers admitted by the Board. However, only the heads of the national supervisory authorities are entitled to vote.

Supervisory Board decisions are to be by simple majority, except for decisions on technical standards and guidelines or financial provisions, when qualified majority voting will apply.

The Management Board is responsible for preparing the ESA's work programme, adopting the rules of procedure and contributing to the adoption of its budget. It comprises the ESA's Chair, a Commission representative and four members elected by the Supervisory Board from its members. The Executive Director may participate in meetings of the Management Board but with no vote.

In addition to the Authorities, colleges of supervisors should be established for all major cross-border firms which should be strengthened, where required, by the participation of representatives of the secretariat of the ESAs as well as ECB observers.

²⁷ COM (2009) 499 final; COM (2009) 500 final; COM (2009) 501; COM (2009) 502 and COM (2009) 503 and COM (2009) 576 final.

²⁸ COM (2009) 252 final.

²⁹ Report of the High-Level Group on Financial Supervision in the EU 25 February 2009 para 185.

The issues arising from these proposals, from the point of view of issuers of securities, are that:

- (a) They have clearly been forged in an environment of economic turmoil, which was caused by the activities of a number of international financial institutions with systemic importance. The economic crisis was not caused by the vast majority of issuers of securities listed on EU stock exchanges. Yet, there is no acknowledgement that a one-size-fits-all approach to financial regulation is not appropriate. There have been many issues arising from the new laws and regulations which have already come out of the Lamfalussy process. The QCA believes that the Commission has finally recognised, following its recent consultation on the Prospectus Directive, that there is a compelling case for a less prescriptive regime for smaller issuers. We need to remain careful to ensure that the needs of small and medium-sized businesses are not simply submerged in the need to regulate large and complex multi-national financial services businesses.
- (b) The creation of the ESRB with a clearly extremely close connection to the ECB does not necessarily help in the regulation of financial markets participants who are not banks. Indeed as financial services regulation in the UK at the current time is primarily the FSA's jurisdiction, it is arguable that the predominant role of the central bank in the new EU system does not reflect our domestic arrangements—with the result that the central bank will have a regulatory function to perform in an EU setting that does not reflect its domestic regulatory brief. This will inevitably mean that those issues with which the Bank of England is concerned are likely to find their way to the top of the ESRB agenda. We suspect there will develop a tendency to push other pressing issues further down the agenda, unless some domestic regulatory process is developed to reflect the EU situation. The proposed ability for the Governor of the Bank of England to be shadowed by the Head of the FSA, or some other domestic regulatory authority depending on the subject matter on the agenda, at any particular meeting of the ESRB has a particular touch of “Heath Robinson” about it.
- (c) There is also a concern that the whole ESRB concept is Euro-area dominant. As the largest EU economy outside the Euro area and having the largest financial services sector in the EU, the UK needs to be alive to a level of general hostility to its markets and market practices which is fairly widespread in the EU. While there can be no getting away from the depth of the financial crisis in 2007–08, the desire to regulate is creating opportunities for some to pursue agendas and achieve outcomes which are not strictly within the ambit of the issues which caused the crisis.
- (d) The promotion of CESR to become the ESMA requires its activities to be put on an altogether far more professional basis. It is hard to argue against that as a concept. Indeed the history of the proposals to date show that the voting arrangements have been heavily negotiated to now provide that only the heads of the home state regulators can vote while the Chair, the Commission representative and others are unable to do so.
- (e) The concept of “colleges of supervisors” is not one we are familiar with in the UK. The idea that some of our largest financial services businesses will have boards of European academics playing a significant regulatory role is likely to cause a few heads to turn. However, provided this arrangement is reserved for financial services businesses of systemic importance, we do not think it will fundamentally affect the issuers we represent.

3. *Are the powers proposed for these bodies appropriate?*

The ESRB will have no authority to impose its views. It will exert influence by providing macro-prudential assessments, issuing risk warnings and recommendations and identifying potentially systemic imbalances and remedial actions. It will not be limited to specific types of entity or market. It should also cooperate with international financial institutions and third country bodies on issues related to macro-prudential oversight.

It is thought that ESRB risk warnings should prompt early responses to avoid the development of larger problems, and addressees of ESRB recommendations are expected to communicate actions taken to follow recommendations or explain reasons for inaction.

When a two-thirds qualified majority of the General Board agrees, warnings and recommendations can be published and can be issued to the Community as a whole, individual Member States, one or more ESAs and one or more national supervisory authorities.

The ESRB will be accountable and regularly report to the Council and the European Parliament. While it is thought that more frequent reporting would be likely in the event of widespread financial distress, ESRB has no direct crisis management responsibilities.

The ESAs will take on all the tasks of the existing Level 3 committees, but, in addition, have significantly increased responsibilities, legal powers and authority to:

- (i) Develop technical standards leading to a single EU rule book for all financial institutions, removing differences in national transposition of EU law. The technical standards will be adopted by qualified majority of the members of the Boards of Supervisors. The Commission must endorse these standards as regulations or decisions to give them direct legal effect.

A Stakeholder Group consisting of industry representatives, financial sector employees and users of financial services will be established for each ESA to consult. In addition ESAs can issue recommendations and non-binding guidelines to national supervisory authorities, financial institutions and market participants. Authorities not complying with their guidelines and recommendations should explain their decision to the ESA.

- (ii) ensure consistent application of Community rules;
- (iii) coordinate between national supervisory authorities, particularly where adverse developments potentially jeopardise the orderly functioning and integrity of the EU financial system;
- (iv) settle disagreements between national supervisory authorities;
- (v) promote the efficient and consistent functioning of colleges of supervisors and monitor coherence in the implementation of Community legislation across colleges;
- (vi) play an active role in building a common European supervisory culture and ensuring uniform procedures and consistent supervisory practices throughout the EU;
- (vii) monitor, assess and report on trends, potential risks and vulnerabilities in the banking, insurance and securities sector;
- (viii) serve as contact points for third country supervisory authorities including entering into administrative arrangements with international organisations and the administrations of third countries;
- (ix) collect information from Member State regulatory authorities; and
- (x) cooperate with ESRB.

However Member States may notify an ESA and the Commission that its national supervisory authority will not implement the ESA's decision taken under the emergency decisions or settlement of disagreements provisions where it impinges on domestic fiscal responsibility. ESA must maintain, amend or revoke its decision within a month. Where the ESA maintains its decision, the Member State may refer the matter to the Council and the ESA's decision is suspended. The Council shall, within two months, decide whether the decision should be maintained or revoked, acting by qualified majority.

The powers proposed for the ESRB seem fitting for a body of this kind. However, the absence of any direct crisis management responsibilities seems strange given the jurisdiction of the ESRB and the level of knowledge which is likely to sit in it by the time a new crisis develops.

On the other hand, the areas of competence of the European Securities and Markets Authority are far more likely to provide a direct challenge to the FSA's existing regulatory role and to have a direct impact on issuers of traded securities.

Implementation of the existing Lamfalussy directives has created a great deal of dislocation in the financial regulatory space, and, from the point of view of issuers listed on UK markets, not necessarily positive changes. On the contrary, many believe that the UK regulatory environment has gone backwards to some degree. For instance:

- (a) the adoption of the Market Abuse Directive has led to abandonment of a more sophisticated market abuse regime introduced in the UK with the Financial Services and Markets Act 2000;
- (b) the adoption of the Transparency Directive has led to the adoption of a contentious set of accounting standards and the introduction of two competing disclosure regimes for shareholdings in listed issuers;
- (c) the adoption of the Prospectus Directive has fuelled the growth of "exchange regulated" markets, not only in the UK (with AIM and PLUS) but elsewhere in Europe such as Alternext (Amsterdam, Brussels, Paris and Lisbon), the Entry Level market in Frankfurt and AIM Italia in Italy—in each case essentially to stay outside the regime created by Brussels. It has also effectively contributed to the fall in public offers by smaller issuers (eg rights issues and open offers), and played a part in the establishment of a new "Standard Listing" route to the Official List in the UK, which does not comply with the higher level of regulation currently required by both AIM and by the Listing Rules for the Main List; and
- (d) MiFID has caused a wholesale re-write of the UK financial services regulatory regime, the re-categorisation of hundreds of thousands of clients, and the development and implementation of new software systems for virtually every firm involved in the trading of securities.

ESMA's brief to develop further technical standards leading to a single EU rule book gives it a huge amount of power with far-reaching consequences in a quasi-legislative role. While technically the Commission must endorse ESMA's standards, the reality is that proposals from ESMA are likely to be adopted substantially in the form in which they are produced.

The psychological gap between CESR's current functions as a passive advisory organisation and the demands expected of it when it becomes ESMA as an active supervisory authority is quite a leap. This will become particularly acute if the same people are effectively left in the same roles, simply being expected to perform them differently. Much of the outcome of these changes will depend on the personalities of those

involved at the centre. For instance, it will take a very different mind-set to be able to settle disagreements between national supervisory authorities, and to play an active role in building a common EU supervisory culture.

4. *The proposals' effect on the competitiveness of the European financial industry in general and the City of London in particular.*

We have no comments on the proposals' effect on the competitiveness of the European financial industry in general. As the City of London is home to a sophisticated capital raising market for companies of all sizes, with all the additional services required to sustain such a market (including legal, accountancy, pr, investment banking and broking), we do not believe that there is significant competition elsewhere in Europe which is likely to be able to use the establishment of ESMA to significantly advance their domestic capital markets to the detriment of London. The real issue is simply that things could be made more difficult and, consequently, more expensive, for issuers for no demonstrable benefit for issuers, investors, advisors or regulators.

5. *The timescale for agreeing the legislation.*

This legislation has been pushed through the EU process at an extremely fast pace. We have been used to EU Directives taking years to get to the statute book. Yet this legislation was conceived in a report first published at the end of February 2009. Specific legislative proposals were published towards the end of September with a further "omnibus directive" to amend existing legislation being published at the end of October.

The need for the stand alone "omnibus directive" could be taken as proof in itself that the political process is moving rather faster than the legislative machinery can catch up.

While the need to act and to be seen to act quickly is important, it is difficult to imagine how, in particular, the ESAs will be equipped to take on the additional responsibilities to be required of them in the space of time they are being given to get themselves in order. The legislation feels, to an extent, that it is being pushed through before the present EU Commissioners come to the end of their respective terms and are either replaced or reshuffled.

Due to the pace at which the legislation is being pushed through, there are bound to be a number of issues arising which will not be picked up until the legislation is in force. It is likely to take considerable time to pass the necessary amending legislation. For instance, when the Prospectus Directive was introduced, there was a mistake made in the technical requirements for historical financial information. It took about 20 months to introduce a relatively simple amendment to rectify the situation. This legislation is ripe for producing unintended consequences.

17 November 2009

Written evidence submitted by NYSE Euronext

1. INTRODUCTION

1.1 NYSE Euronext welcomes the opportunity to provide evidence to the Treasury Committee in relation to the Committee's inquiry into the European Commission's proposals for financial regulation and supervision, set out in the Commission's July communication on *European Financial Supervision* (COM (2009) 252), and its follow-on October Communication *Ensuring efficient, safe and sound derivatives markets: Future policy actions*, (COM (2009) 563/4).

1.2 NYSE Euronext is a leading global operator of financial markets and a provider of innovative trading technologies. NYSE Euronext's exchanges in Europe (London, Paris, Amsterdam, Brussels and Lisbon) and the United States provide for the trading of cash equities, bonds, futures, options, and other exchange-traded products. NYSE Liffe is the name of NYSE Euronext's European derivatives business and is the world's second-largest derivatives business by value of trading. The majority of NYSE Liffe's operations are located in the City of London. The London arm of NYSE Liffe, LIFFE Administration and Management, is a self-clearing Recognised Investment Exchange which is overseen by the Financial Services Authority.

1.3 NYSE Euronext therefore has a strong interest in ensuring that there is a proportionate and workable regulatory regime within Europe within which it can provide its services in an efficient manner in order to meet the needs of investors and other market users.

1.4 Generally speaking, NYSE Euronext supports the European Commission's proposals for enhanced macro-prudential and micro-prudential supervision. However, there is one particular aspect of the proposals for micro-prudential supervision that NYSE Euronext does not support: the proposal for "EU central counterparty clearing houses" to be authorised and supervised direct by the European Securities and Markets Authority ("ESMA"), rather than by the relevant national authorities. The arguments against such a move are set out in paragraphs 3.5 and 3.6 below.

2. MACRO-PRUDENTIAL SUPERVISION

2.1 NYSE Euronext provides a good example of how EU, national and international regulatory and supervisory arrangements already interact successfully. The five European exchanges run by NYSE Euronext each continue to be regulated by their national regulators, which also meet as a College to address matters affecting all five markets and agree a harmonised approach to dealing with them. This arrangement was the first of its kind, and has been described to be “proving efficient” by the regulators themselves. Throughout the recent global financial crisis NYSE Euronext’s markets have continued to function robustly and reliably.

2.2 Nevertheless, the financial crisis exposed some serious failures in financial supervision. The European Commission’s proposal for the creation of a European Systemic Risk Board (previously termed a “Council” in its July Communication on *European Financial Supervision*, (COM (2009) 252)) stems from its analysis that, in the light of the crisis, the EU needs a specific body responsible for macro-prudential oversight across the EU financial system as a whole, and within a global context.

2.3 NYSE Euronext agrees with the Commission’s analysis, and believes it is appropriate for a body like the proposed European Systemic Risk Board to be established in order to provide a broader perspective through the monitoring and assessment of potential risks to overall financial stability arising from developments at sectoral or systemic level. In establishing such a body, NYSE Euronext would emphasise that it is important that:

- (a) the body is fully accountable to the European Council and the European Parliament; and
- (b) the body does not operate in isolation, but works effectively with:
 - (i) the proposed European System of Financial Supervisors (“ESFS”), which will be responsible for micro-prudential supervision in Europe;
 - (ii) macro-prudential bodies outside Europe, in particular the Financial Stability Board and the authorities in the United States; and
 - (iii) private sector stakeholders.

3. MICRO-PRUDENTIAL SUPERVISION

3.1 NYSE Euronext understands that at the level of micro-prudential supervision the Commission proposes that the ESFS should be an operational European network, comprising three new European Supervisory Authorities (including ESMA) which will be responsible, among other things, for setting binding principles and standards, and national authorities which will generally continue to be responsible for conducting day-to-day authorisation and supervision of individual entities. NYSE Euronext believes that whilst the “European System of Financial Supervisors” is key to ensuring a stable and single EU market for financial services, the right balance between national bodies and supra-national bodies must be found in the overall framework for the supervision of securities and derivatives markets, as proximity to the market is particularly important.

3.2 NYSE Euronext strongly supports the concept of national authorities continuing to be responsible for the authorisation and supervision of individual entities—albeit within a more cohesive set of EU-wide standards and principles—and is concerned about the aspects of the proposals by the European Commission which would undermine that concept.

3.3 In May 2009, the European Commission published a Communication proposing that the European Supervisory Authorities:

“shall be given the responsibility for the authorisation and supervision of certain entities with pan-European reach, eg credit rating agencies and EU central counterparty clearing houses. These responsibilities could include such powers as those of investigation, on-site inspections and supervisory decisions.”³⁰

In relation to central clearing counterparties, NYSE Euronext raised its concerns about this departure from the concept that day-to-day authorisation and supervision of individual entities should be conducted by national authorities. On 19 June 2009, the European Council endorsed the Commission’s Communication, with the exception of the proposal that central counterparties should be authorised and supervised at EU level. When in September 2009 the Commission published draft legislation which would give effect to the proposals contained in its Communication, this followed the European Council endorsement by omitting the proposal to which NYSE Euronext had objected.³¹

3.4 However, the latest European Commission Communication, *Ensuring efficient, safe and sound derivatives markets: Future policy actions* (COM (2009) 563/4), effectively restores the contentious proposal that one of the European Supervisory Authorities, ie ESMA, should authorise central counterparties within the European Union. It also reserves the possibility that it will “grant ESMA direct supervisory powers in

³⁰ Section 4.2(4), COM (2009) 252 Final.

³¹ COM (2009) 503 Final.

view of the specific nature and in particular the pan-European reach of central counterparties". NYSE Euronext notes that the dividing line between "authorising" activities and "supervisory" activities may in practice be difficult to define.

3.5 NYSE Euronext fully appreciates the importance of the role of EU central counterparties ("CCPs"), not least because it operates a CCP itself in respect to its London-based, LIFFE market. However, NYSE Euronext continues to disagree with the Commission's proposals in relation to the authorisation and supervision of such CCPs. This idea, that regulated markets and their respective CCPs should be supervised at different levels, is undesirable and impracticable for the reasons set out below:

- (a) NYSE Euronext believes that the national supervision of CCPs during the financial crisis has worked well. No CCP has been in distress—or in receipt of government funding—during the period of financial turmoil. On the contrary, the CCPs have played an important part in managing the consequences of the default of major financial institutions, such as Lehman Brothers. There has been no market failure with respect to the supervision or operation of CCPs.
- (b) Worldwide, the majority of exchange-traded derivatives business is organised on a vertically-integrated basis, so that trading and clearing operate under the same umbrella. Therefore, there would be potential regulatory gaps or overlap if the supervision of the clearing operations of an exchange was moved to a body other than the national authority responsible for the integrity of the trading operations of that exchange. This runs the risk of poor and inefficient supervision, contrary to the best interests of ensuring market integrity. In the case of on-exchange derivatives markets, like NYSE Liffe's, where contracts are held open for months if not years, regulation of the market must encapsulate both trading activity (ie the flow of transactions on a daily basis) and open positions (ie the stock of outstanding transactions). Trading takes place on the regulated market, while resultant positions are held with the CCP. Such positions can and do have an impact on future activity on the market and issues concerning them are, in many cases, the key factors which must be managed actively in respect of the maintenance of contract and market integrity. To separate artificially the levels at which the regulated market and CCP are supervised, (at national and supra-national levels respectively) as the Commission proposes, would not recognise this integral interaction and would not be in the best interests of effective regulation.
- (c) A move to supervise CCPs at European level but continue to rely on national taxpayers to underwrite them (in the albeit unlikely event of their insolvency) creates the possibility of a situation, in the UK's case, where the British taxpayer could end up picking up the bill for a failure of supervision at the European level. While it is not possible to quantify the cost of such underwriting precisely, as the size of any shortfall would depend on the particular circumstances of the crisis in question, the amount would potentially be significant given the extensive financial exposures that CCPs, and particularly derivatives CCPs, manage.
- (d) Several major European markets, including Deutsche Borse and the London derivatives arm of NYSE Euronext, operate integrated trading and clearing services. NYSE Euronext believes that the general move to amalgamate previously separate regulatory bodies within one country, as exemplified by the FSA in the UK, serves to promote the consistency of the regulatory approach across business activities—particularly in respect of those which are complementary to one another—and NYSE Euronext would be seriously concerned about any development which fundamentally undermined this model.

3.6 NYSE Euronext is also concerned that, if the proposed change is enacted, the consequence will be an additional regulatory burden that will increase NYSE Euronext's own costs, and make it less competitive in the global marketplace, which is highly cost-sensitive. Competition in the listed derivatives markets is global by its nature, and an increase in the regulatory burden will place NYSE Euronext at a disadvantage compared with its competitors in North America and in the Asia-Pacific region, potentially leading to a loss of business to exchanges in other jurisdictions which will not be disadvantaged by these proposed regulatory changes, should they become law within the European Union.

4. CONCLUSION

4.1 NYSE Euronext supports the European Commission's proposals for enhanced macro-prudential and micro-prudential supervision, including a central and substantive role for ESMA and the other European Supervisory Authorities in setting binding standards and principles which NYSE Euronext contends should then be applied by national authorities.

4.2 However, there is one aspect of the proposals which NYSE Euronext does not support, which is the suggestion that central counterparties should be authorised and, in particular, supervised, by ESMA itself. NYSE Euronext believes strongly that such functions should continue to be undertaken by the relevant national authorities, albeit within a framework established by EU law and ESMA standards.

20 November 2009