



Shifting Powers:

What the EU's financial supervisors will mean for the UK and the City of London

Updated edition

October 2010

Copyright © 2010 Open Europe

Open Europe
7 Tufton St
London
SW1P 3QN
www.openeurope.org.uk

ISBN: 978-1-9077668-17-3

CONTENTS

<i>Chapter</i>	<i>Page</i>
What they say about the new EU supervisors	2
Executive summary	3
1. The voting structure: heavily biased against the UK	5
2. The supervisors' powers: beyond the original mandate?	6
3. The supervisors are likely to take on more powers over time	9
4. The rise of the European Securities and Markets Authority	11
5. Benefits and risks	15
5.1 Flow of information and host-home country resolutions	15
5.2 Supervisory fudge can lead to uncertainty and contradictions	15
5.3 Breaking the link between supervision and fiscal authority	16
5.4 The "fiscal safeguards" are not watertight	18
5.5 The risk of hijack	19
5.6 The single rulebook: the City will benefit if the UK writes it	20
Annex I: How will the ESAs' powers over national authorities work?	22
Annex II: Laws under the ESAs' control	26

WHAT THEY SAY ABOUT THE NEW EU SUPERVISORS

“This is just a first step [...] we will dispose of a framework in which the Commission will continue brick by brick, piece by piece, to propose elements.”

- EU Commissioner for Internal Market and Financial Services, Michel Barnier, 2 September 2010.¹

“We have agreed a European system of supervision with binding powers. My conviction is that its scope will increase [...] This is a point of departure. In the future there will be an evolution. Institutions end up doing more than foreseen.”

- French President Nicolas Sarkozy, 20 June 2009.²

“We can’t foresee the evolution in five or ten years’ time but we know that there are already global stakeholders calling for something more.”

- Salvatore Gnoni, Securities Markets Unit, Internal Market DG, European Commission, 12 July 2010.³

“The supervisory package currently under consideration and based on the conclusions of the de Larosière group constitutes an important step ahead. However, further steps will be needed for the future structure of EU supervision if we want to avoid crises in future.”

- Pervenche Berès MEP, member of the EP Committee on Economic and Monetary Affairs, 28 July 2010.⁴

“No actor, no product, no sector, no territory should no longer be able to escape sensible and intelligent regulation and supervision.”

- EU Commissioner for Internal Market and Financial Services, Michel Barnier, 6 September 2010.⁵

¹ *European Voice*, “Deal struck on financial reform”, 2 September 2010

<http://www.europeanvoice.com/article/2010/09/deal-struck-on-financial-reform/68782.aspx>

² *Times*, “Jubilant Sarkozy sees EU take powers over the City”, 20 June 2009

<http://business.timesonline.co.uk/tol/business/economics/article6539207.ece>

³ Speaking at an Open Europe event: “EU supervision and regulation in the securities markets – Will one size fit all?”, 12 July 2010

<http://www.openeurope.org.uk/events/>

⁴ From an opinion piece written for Greek think-tank ELIAMEP and quoted in *EurActiv*, “First step towards ‘twin peaks’ model of financial supervision”, 28 July 2010

<http://www.euractiv.com/en/financial-services/first-step-towards-twin-peaks-model-financial-supervision-analysis-496770>

⁵ *CNBC*, “No bank will escape from regulation: EU officials”, 6 September 2010

<http://www.cnbc.com/id/39023082>

EXECUTIVE SUMMARY

- **Power over national authorities in seven new areas:** The proposal represents a clear shift from national regulators to the EU. The three EU supervisors will be given binding powers over national supervisors in seven broad areas – in three of these areas the supervisors will have the power to address individual firms directly if national regulators do not comply with a decision. The supervisors will be allowed to interpret, apply and enforce provisions in over 20 separate EU laws, with several additional laws set to fall under their authority within the immediate future. For the time being, day-to-day supervision will remain with national authorities, however.
- **The voting structure in the supervisors is heavily biased against the UK:** As a rule, decisions within the supervisors will be taken by *simple* majority. In a few cases, qualified majority voting (QMV) will be used. The UK will only have 3.7 percent of the votes within the supervisors under simple majority and 8.4 percent under QMV – despite being home to 36 percent of the EU’s wholesale finance market. In contrast, Germany and France, which control respectively 13 percent and 11 percent of the EU market, will have the same voting weight as the UK. Poland, for example, has 0.3 percent of the EU market but will have the same voting weight as the UK under simple majority, and only marginally weaker under QMV. This means that the UK will only have very limited ability to block measures that it may not agree with.
- **The EU supervisors are likely to take on more powers over time:** As Internal Market Commissioner Michel Barnier has said, the creation of the supervisors is only “a first step”. The incremental extension of powers is an inherent feature in the design of the new supervisory structure. First, there are “review clauses” in the proposal which can be used to augment the supervisors in future. Secondly, the powers of the supervisors can be extended at any given time through new Directives or amendments to existing ones. There are currently several proposals in the pipeline which could substantially boost the powers of the EU supervisors. In particular, the European Securities and Markets Authority is likely to grow in prominence. For example, it could be given the final say over bans on short-selling, clearing of derivatives contracts and market access for offshore funds. It is far from clear that such a development is in the best interest of the City of London. The Commission has also vowed to introduce an EU-wide deposit insurance scheme “in the longer term”.
- **A useful forum for exchanging information and supervising cross-border banks:** The proposal has its merits. For example, as the Turner Review has argued, the financial crisis illustrated that there is a need for more exchange between national regulators and others, as well as a need for gathering and analysing information at an international level – for example on the risk exposure of large cross-border institutions or systemic risk more widely. The supervisors could also serve to clarify responsibilities in cases when the failure of a bank, based in one country, exposes depositors and taxpayers in a different country to risks.
- **Supervisory fudge can lead to uncertainty and confusion:** But in many areas, splitting key supervisory powers between national and EU regulators risks creating more, not less, confusion about who exactly is responsible for overseeing the financial markets, who makes decisions and, crucially, where accountability lies.

Ambiguity over where ultimate responsibility lies has often been identified as one of the key failures in the UK's 'tripartite' regulatory system. The risk is that the UK now repeats past mistakes by signing up to a structure which creates a new fudge. For example, if there is ambiguity over the emergency powers of the EU supervisors in individual laws, this could lead to a lack of clarity about who is ultimately responsible for acting in a crisis. Instead of having a calming effect, this could add to investor uncertainty and public anxiety, in addition to wasting valuable time.

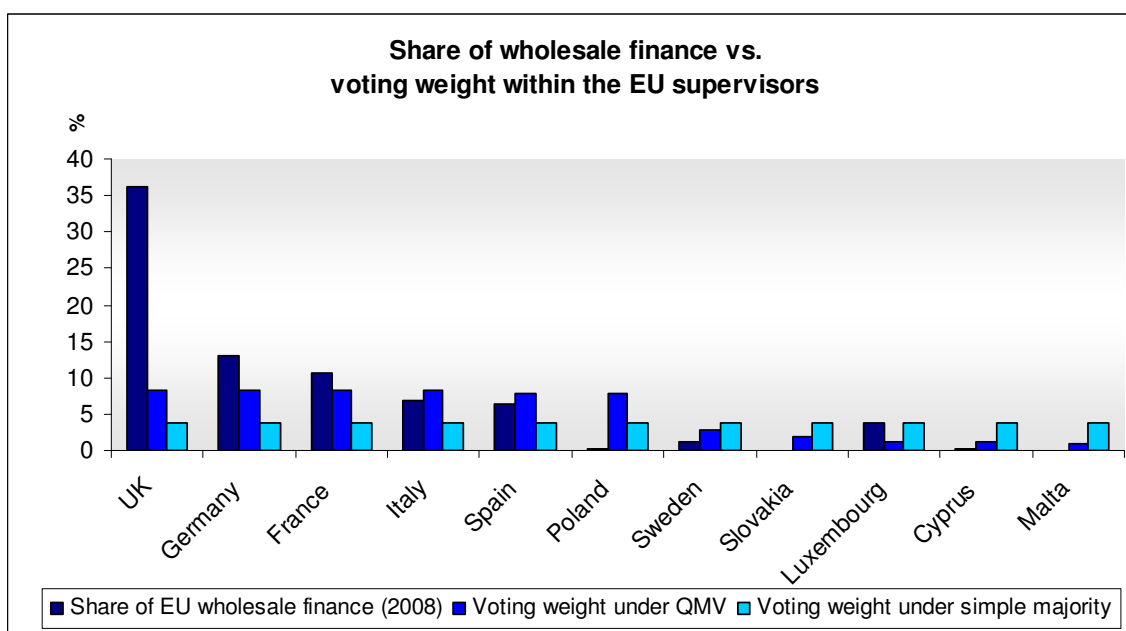
- ***Breaking the link between financial supervision and fiscal responsibility:*** The EU supervisors will have the final say on some key supervisory issues, but national governments will continue to be the sole source of fiscal support if institutions fail. This mis-match can create contradictions and raises questions about the effectiveness of the new system. The alternative would be an EU-wide deposit scheme for cross-border institutions, but this option throws up a number of problems of its own, including the risk of moral hazard.
- ***The “fiscal safeguards” are not watertight:*** Member states do not have a veto over decisions by the supervisors with a possible impact on national fiscal authority. Instead, member states have a right to appeal a decision, but only when it has “significant or material” impact on the expenditure side of their budgets. The EU supervisor’s decision can then be overturned only by a simple majority vote in the Council of Ministers.
- ***Supervisors could be hijacked by narrow political or commercial interests:*** The combination of simple majority to reach decisions within the supervisors (as a rule), the absence of clearly defined powers for the new bodies (as new Directives could fall under their authority at any given time), and the lack of democratic control leaves virtually no safeguard in place to ensure that these new bodies are not hijacked by narrow agendas – whether political or commercial. The power to restrict activities, for example short-selling, could be particularly vulnerable to this.
- ***A “single rulebook” could benefit the City but that assumes the UK will write it:*** The supervisors will be given the power to impose Single Market standards and enforce EU laws. This could benefit the City of London, through more consistent application of EU rules. However, it could also expose the City to unwelcome intrusions, particularly as all decisions will be taken by majority vote in a forum consisting of supervisors, many of whom tend to take a stricter view of how financial markets should be regulated.
- ***The UK government must build alliances and resist further expansions of power:*** Moving forward, the UK government must intensify its efforts to build alliances with countries around Europe, to ensure that the new supervisors aren't hijacked by political or protectionist interests in future. It should also step up its negotiation efforts on EU financial legislation currently in the pipeline, including the AIFM Directive, rules on short-selling and upcoming proposals for tighter regulation of derivatives. These proposals could all be used to extend the supervisors' powers to the detriment of the City of London.

1. THE VOTING STRUCTURE: HEAVILY BIASED AGAINST THE UK

As a rule, decisions within the supervisors will be taken by *simple* majority meaning that the UK has the exact same voting weight as all other EU member states, despite being home to the bulk of the bloc's financial sector. For decisions on technical standards qualified majority will be used (which would give the UK a slightly stronger relative say).

The rationale for this is clearly that while the UK may be home to the EU's biggest financial centre, the exposure stemming from risks in the financial sector is spread across Europe and should be reflected in the way the supervisors take decisions. This could perhaps be justifiable if the supervisors' responsibilities centred around coordination of the supervision of cross-border banking. But as we note below, the proposal goes far beyond surveillance of retail banks.

Therefore, in many areas, the voting structure in the supervisors is grossly biased against the UK, relative to Britain's share of the EU's financial market. The UK controls 36 percent of the EU's wholesale finance market, but will only have 3.7 percent of the votes within the supervisors under simple majority and 8.4 percent under QMV. In contrast, Germany has 13 percent of the market, and France 10.7 percent – but both will have the exact same voting strength as the UK. In even starker contrast, Poland picks up a 0.3 percent share of the EU's market in wholesale finance, but will get 3.7 percent of the votes under simple majority and 7.8 percent under QMV.



Source: City of London, "The Importance of Wholesale Financial Services to the EU economy", September 2009⁶

⁶ See http://217.154.230.218/NR/rdonlyres/DF649F73-2F5D-4C3E-AA24-E491A280A9B5/0/BC_RS_ImportanceofWholesaleFStoEUEconomy09.pdf (page 33)

"Wholesale finance" is defined in this report as "the provision of services by financial institutions to corporate clients, investors, institutions and public sector bodies, as well as well as to other financial institutions".

Wholesale finance services contrast therefore with *retail* financial services, which involve the provision of financial services to individuals. QMV weight is calculated on the basis of the transitional provisions outlined in Protocol 36 annexed to the Lisbon Treaty. These provisions are to be changed after 31 October 2014

2. THE SUPERVISORS' POWERS: BEYOND THE ORIGINAL MANDATE?

The three EU watchdogs will be given powers over national supervisors in seven broad areas – in three of these areas the supervisors will have the power to address individual firms directly if national regulators do not comply with a decision (see box below). The three supervisors will be allowed to interpret, apply and enforce provisions in over 20 separate directives and regulations⁷, with several additional EU laws set to fall under their authority within the immediate future (see Annex II).

The powers of the EU supervisors⁸

Power	Voting procedure	Can member states appeal a decision?
<i>Power to address financial institutions directly in “emergency situations”</i>	<i>Simple majority within the Board of Supervisors</i>	<i>Yes, if it has a “significant or material” impact on their fiscal sovereignty</i>
<i>Power to impose temporary bans on “toxic” financial products and activities</i>	<i>Simple majority within the Board of Supervisors</i>	<i>No</i>
<i>Power to address financial institutions directly in the settlement of disputes between national regulators</i>	<i>Simple majority within the Board of Supervisors</i>	<i>Yes, if it has a “significant or material” impact on their fiscal sovereignty</i>
<i>Power to address financial institutions directly in case of breaches of EU law</i>	<i>Simple majority within the Board of Supervisors</i>	<i>No</i>
<i>Power to draft binding technical standards</i>	<i>QMV within the Board of Supervisors</i>	<i>Yes, but only before the standards are published in the EU’s Official Journal</i>
<i>Power to issue guidelines and recommendations that national regulators and financial institutions “shall make every effort to comply with”</i>	<i>QMV within the Board of Supervisors</i>	<i>Yes, guidelines and recommendations are not legally binding</i>
<i>Power to coordinate peer reviews between national supervisors</i>	<i>/</i>	<i>/</i>
<i>Exclusive supervisory powers over credit rating agencies (ESMA only)</i>	<i>Unclear, probably simple majority within the Board of Supervisors</i>	<i>/</i>

⁷ A total of 24 legislative acts including: the future AIFM directive, the future regulation on credit rating agencies, the future regulation on OTC derivatives and the future regulation on short-selling and CDS

⁸ For a detailed description of the EU supervisors’ powers see Annex I

This has clearly taken the supervisors beyond the original recommendations made in the two most influential reports paving the way for their creation – the Commission-sponsored de Larosière report and the Turner Review for the UK's FSA.

The de Larosière report focused primarily on the need to establish the European Systemic Risk Board, to serve as an “early warning” system for threats to overall financial stability.⁹ On micro-prudential supervision, the report gave little detail but called for “strengthened coordination” between national supervisors and standards. It also stated that,

“[The EU supervisors] should be neutral with respect to national supervisory structures: national supervisory structures have been chosen for a variety of reasons and it would be impractical to try to harmonise them.”¹⁰

On the need for EU reform, the Turner Review focussed most of its attention on prudential supervision of cross-border banks and how best to insure against the failure of large institutions with operations in several countries.¹¹ Both reports stressed the need to give the host country input into the running of subsidiaries of cross-border banks – for example on branch liquidity.

But the proposal for EU supervision which is now being adopted has not stopped there. Instead the supervisors have been given a range of powers which can be broadly grouped into three categories (with substantial overlap between the three):

- **Emergency powers:** The ESAs will be allowed to take action after the Council of Ministers has declared an “emergency” (through a majority vote) and would be allowed to address firms directly if national supervisors fail to comply. The proposal does not specify what actions this could involve or to what end – this will in large part be decided by provisions in individual directives, through amendments to existing directives or the introduction of new ones.

ESMA and the other supervisors will also be allowed to ban “toxic” products or limit certain practices – even without an emergency having been called – if these are considered to “threaten the stability” of the EU’s financial system. Again, details about what such restrictions involve will primarily be decided as separate directives are introduced or amended – although according to proposals recently tabled by the Commission this could include temporary restrictions on short-selling and CDS activities (see below).

- **Crisis prevention and management:** These powers involve giving the supervisors binding powers to settle disputes between national supervisors (for example in a

⁹ “The High-Level Group on Financial Supervision in the EU”, chaired by Jacques de Larosière, 25 February 2009 http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (see page 46)

¹⁰ *Ibidem*, page 48

¹¹ The Turner Review argued, “These current arrangements, combining branch passporting rights, home country supervision, and purely national deposit insurance, are not a sound basis for the future regulation and supervision of European cross-border retail banks. Sounder arrangements require either increased national powers, implying a less open single market, or a greater degree of European integration. A mix of both seems appropriate: the extent to which more national powers are required will depend on how effective ‘more Europe’ options can be”. See “The Turner Review: A Regulatory Response to The Global Banking Crisis”, March 2009 http://www.fsa.gov.uk/pubs/other/turner_review.pdf (page 101)

Landsbanki-type home-host country dispute) and exclusive supervisory powers over credit rating agencies.

- **Single Market powers:** The EU supervisors have also been given what appear to be powers to ensure the consistent application of EU laws across the Single Market. To this effect, the ESA will draw up binding technical standards in a range of different areas, with a view to creating a “single rulebook” for the EU’s Internal Market, overriding the standards set by national regulators.

The supervisors will also be given the power to intervene, on their own initiative, directly against firms that have failed to implement an EU law correctly, as interpreted by the EU supervisor. This will give the ESA almost judicial-type powers, as interpreting laws is a responsibility usually reserved for the courts. It remains unclear how such powers can be granted to the new supervisors without a change to the EU Treaties. The supervisors will also be given the powers to issue recommendations which national authorities will have to “make every effort to comply with”.

How would the EU supervisors be governed?

Each ESA would be governed by a Board of Supervisors, which includes the heads of the 27 national supervisors (the FSA from the UK). In addition, a chairperson and a representative each from the Commission, the ESRB and the other two ESAs would also sit on the Board as ‘observers’ (without voting rights).

Crucially, as a general rule the Board of Supervisors takes its decisions by *simple majority*, meaning that the FSA representatives would have no veto powers and would have the same voting weight as everyone else, regardless of the size of the markets they are expected to oversee at home.

Decisions will be taken by QMV *only* when the Board votes on the adoption of technical standards and guidelines, or internal budgetary matters.¹² Each Board of Supervisors would be responsible for the adoption of the annual budget of the respective ESA.¹³ The proposed regulations clearly state that the ESAs’ yearly revenue would consist partly of “obligatory contributions from the national public authorities competent for the supervision of financial institutions.” The size of the contributions would be based on share of votes under QMV, meaning that the FSA would be one of the biggest contributors to the supervisors’ budget.¹⁴ Yet, neither the FSA nor the UK government would have a veto over the budget.

¹² See for example http://ec.europa.eu/internal_market/securities/docs/agencies/100602_proposal_en.pdf (page 38)

¹³ <http://register.consilium.europa.eu/pdf/en/10/st12/st12457.en10.pdf> (see page 103)

¹⁴ <http://register.consilium.europa.eu/pdf/en/10/st12/st12457.en10.pdf> (see page 101)

3. THE SUPERVISORS ARE LIKELY TO TAKE ON MORE POWERS OVER TIME

The EU supervisors are likely to take on more powers over time. First, there are “review clauses” in the actual proposal for the supervisors envisioning their evolution, and secondly, the legislation is designed so that at any given time, additional responsibilities can be granted to the ESA through amendments or the introduction of new directives.

This ongoing two-track review arrangement makes the incremental extension of powers an almost inherent feature in the design of the supervisors. As EU Commissioner for Internal Market and Financial Services Michel Barnier has said, “This is just a first step [...] we will dispose of a framework in which the Commission will continue brick by brick, piece by piece, to propose elements.”¹⁵

The so-called “review clauses” have been gradually strengthened throughout the negotiations, following strong pressure from the European Parliament.¹⁶ The final proposal states that,

“Concerning the issue of direct supervision of institutions or infrastructures of pan-European reach and taking account of market developments, the Commission will draw up an annual report on the appropriateness of entrusting the Authority with further supervisory responsibilities in this area.”¹⁷

This opens up the possibility of the British government being outvoted on a future proposal to grant the new bodies more supervisory powers (as such decisions will be taken by QMV). The proposal to be adopted also contains a detailed list of aspects the Commission would be expected to analyse in a separate, three-yearly report, including the need to strengthen the supervisors and merge them into one entity with a single seat¹⁸. The European Parliament is likely to continue to argue for the three bodies to be merged into a single supervisor with a single seat (Frankfurt has been MEPs’ location of choice so far).

The powers of the EU supervisors could also be extended at any point in time through new directives or amendments to existing ones. For example, the AIFM Directive, currently subject to negotiations between the Council, the EP and the Commission, would most certainly fall under the authority of the European Securities and Markets Authority (ESMA). So would new directives on short-selling and derivatives which the Commission tabled in September 2010 (see below).

¹⁵ *European Voice*, “Deal struck on financial reform”, 2 September 2010

<http://www.europeanvoice.com/article/2010/09/deal-struck-on-financial-reform/68782.aspx>

¹⁶ Article 66 of the Commission’s original draft provided that “the Commission shall publish a general report on the experience acquired as a result of the operation of [the ESAs].” This document was to be released every three years and was merely intended to be an assessment of “progress achieved towards regulatory and supervisory convergence [in the EU]”. See the original proposal here,

http://ec.europa.eu/internal_market/securities/docs/agencies/100602_proposal_en.pdf (page 55)

¹⁷ <http://register.consilium.europa.eu/pdf/en/10/st13/st13070.en10.pdf> (see page 110)

¹⁸ For example, the Commission should assess whether separate supervision of banking, insurance, occupational pensions, securities and financial markets is proving effective; whether the architecture of the European System of Financial Supervisors (ESFS) needs to be “simplified and strengthened”; and whether the evolution of the ESFS is consistent with global developments

<http://register.consilium.europa.eu/pdf/en/10/st13/st13070.en10.pdf> (see page 110)

The Takeover Directive (excluded from the scope of ESMA in the final text¹⁹), which regulates takeovers in the UK, could also come under the scope of ESMA when the Directive is reviewed in 2011.²⁰ In future, the Commission will also assess the case for establishing a pre-funded insurance scheme at the EU-level (see below).

It has been argued that limited financial resources will inhibit the EU supervisors from taking on more powers over time. The supervisors would start off with around 50 staff each, to reach 100 people within a couple of years.

However, the Commission's proposals clearly show that the budget of the supervisors will rise every year, at least until 2013 (after which a new budget period kicks in for the EU).²¹ In addition to the already planned increases, the size of the budget could be increased every year at the request of the Boards of Supervisors. Each Board will produce annual estimates of revenue and expenditure for the respective EU authority which then must be endorsed by the Council of Ministers (before the final budget is adopted by the Board of Supervisors). As more directives are piled on to the ESA's workload, its resources will have to increase correspondingly.

All decisions about increasing the supervisors' budget will be taken by QMV²², meaning that the UK will not have the power to veto any increases it considers unwarranted. Similarly, the FSA will have no veto rights on the final budget proposal within the Board of Supervisors.²³

Therefore, increasing the ESAs' resources is a mere matter of majority voting in the Council and within the supervisors themselves. This also means that the UK's ability to control the size and powers of the supervisors through its budget contributions is highly limited.

¹⁹ <http://register.consilium.europa.eu/pdf/en/09/st16/st16751-re01.en09.pdf> (see page 21)

²⁰ The UK's Takeover Panel has warned that including the Takeover directive within the scope of ESMA "could fundamentally undermine the proven system of takeover regulation in the UK by: reducing the Panel's ability to make its own rules and apply them flexibly; and providing scope for prolonged disputes and tactical litigation in the course of bids". See the written evidence by the Takeover Panel to the Treasury select committee <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/1088/1088we10.htm>

²¹ See http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_503_en.pdf (page 70)

²² <http://register.consilium.europa.eu/pdf/en/10/st13/st13070.en10.pdf> (see pages 77 and 97-98)

²³ The FSA will be one of the biggest contributors to the budget of the supervisors, since contributions coming from national regulators are based on the weighting criteria used for the QMV system. In other words, the FSA will be one of the largest contributors to the EU supervisors, but will not be allowed to veto their budgets if it deems them excessive. See <http://register.consilium.europa.eu/pdf/en/10/st13/st13070.en10.pdf> (see page 96)

4. THE RISE OF THE EUROPEAN SECURITIES AND MARKETS AUTHORITY

The most powerful of the three new bodies is likely to be Paris-based ESMA – despite the fact that the overwhelming part of the recommendations preceding the proposal related to banking supervision.

ESMA will initially be given the mandate to monitor 13 separate EU Directives but is set to extend its powers considerably when a series of new proposals from the Commission comes in to force. These include giving ESMA exclusive powers to supervise credit rating agencies²⁴ – making it the first pan-EU regulator with exclusive supervisory powers – and the mandate to apply provisions in the controversial AIFM Directive. In addition, the Commission has proposed giving ESMA the powers to temporarily ban or restrict short-selling or CDS activities as well as direct supervisory powers over derivatives clearings. The new supervisor would almost certainly have to be given more resources in order to deal with all these responsibilities.

The AIFM Directive

The AIFM Directive, currently in the final stage of negotiations, will fall under the scope of ESMA. Crucially, following French demands, ESMA could be given an exclusive mandate to grant funds and managers based outside the EU a so-called ‘passport’ – which would allow them to market their products throughout the bloc based on a single authorisation.

The ‘passport’ provision and the rules for funds and managers based offshore have been the most contentious aspect of the proposal throughout the negotiations.²⁵ Critics, including US Treasury Secretary Timothy Geithner, have warned that failure to grant offshore funds and managers’ market access equal to that of EU funds would amount to protectionism and could trigger retaliatory action.²⁶

While the industry has pushed hard for the passport provision – to avoid having to seek separate authorisation in 27 different member states – giving ESMA exclusive powers to issue a passport would concentrate an absolutely vital power at the EU-level, with few checks and balances in place to make sure the process is not hijacked by protectionist interests. Again, the UK, where most fund managers running offshore funds are based, will only have one single vote within the new supervisor on most decisions. It is perhaps instructive to note that France only gave up its resistance to the provision on condition that ESMA would be given the exclusive powers to issue passports, possibly seeing an opportunity to attach strict conditions to the passport through the new EU supervisor by outvoting more liberally inclined member states, such as the UK.

²⁴ Under the proposal to amend Regulation 2009/1060/EC on credit rating agencies

²⁵ For a detailed discussion, see *Open Europe*, “The EU’s AIFM Directive: Likely Impact and Best Way Forward”, 21 September 2009

<http://www.openeurope.org.uk/research/aifmd.pdf>

²⁶ *Reuters*, “Geithner warns EU on hedge-fund law”, 7 October 2010
<http://www.reuters.com/article/idUSLNE69603020101007>

Under the most recent draft, ESMA would also be given powers to decide in which countries funds are allowed to deposit their cash and assets (i.e. whether a jurisdiction in which a depository is established is subject to “prudential supervision”).²⁷

Furthermore, ESMA would have the mandate to request national regulators to impose additional reporting requirements for funds and would also adopt guidelines on “sound remuneration policies.”²⁸ It would not, however, have the mandate to set down limits on the amount of money fund managers are allowed to borrow. Such decisions would be left with national regulators.

Regulation on derivatives

In September 2010, the European Commission tabled a proposal for stricter regulation of derivatives. Unlike the new rules for alternative investment funds, this proposal is an EU Regulation – not a Directive – meaning that member states will have no discretion in implementing it. ESMA plays a key role in this proposal, and appears to be given powers to directly supervise derivatives trading at different stages, including:

- ESMA would become the sole authority responsible for registering and overseeing trade repositories – the new bodies in charge of collecting and making available information on OTC derivatives – including the right to ask the Commission to impose fines on trade repositories and withdraw their registration at any time.²⁹
- ESMA would have to authorise CCPs in third countries before they can provide services within the EU, on condition that these CCPs are subject to a level of supervision similar to that exercised in the EU.³⁰
- If a CCP would decide to clear a contract, and after it has received the go-ahead from the national regulator, the CCP is obliged to inform ESMA. The EU supervisors would then decide whether that contract would require clearance across the EU as a whole.³¹
- ESMA (together with the ESRB) would also determine which contracts should be subject to the clearing obligation on an ongoing basis, even if a particular trade has not been notified by a CCP.³²

Subjecting more OTC derivatives to central clearing and more transparency is a good idea. However, the proposal clearly represents a shift away from national regulators to the EU-level and puts new, wide-ranging powers at the hands of ESMA. Quite irrespective of the merits of more clearings, this should be acknowledged.

²⁷ The Council and the EP seem to be converging on this point, see Article 5 (b)ii of the latest draft proposal from the EU Presidency. In the Presidency’s latest draft, ESMA would also be given the power to request national authorities to impose additional reporting requirements on fund managers, for example on private equity firms. See <http://register.consilium.europa.eu/pdf/en/10/st12/st12953.en10.pdf>

²⁸ *Ibidem*, page 28

²⁹ http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf (See page 56)

³⁰ *Ibidem*, page 35

³¹ *Ibidem*, page 6

³² *Ibidem*, page 25

As with the AIFM Directive, ESMA could also serve as a “gatekeeper” for companies (in this case CCPs) which wish to operate in the EU. Again, the risk is that the voting process within ESMA becomes politicised, which in turn could lead to unnecessarily restricted market access.

On top of these powers, the Commission’s proposal also gives ESMA the mandate to impose binding “technical” standards in 14 different areas including,

- The threshold for when non-financial counterparties – which currently are exempted from the Directive – will be subject to the clearance obligations;
- The criteria for ‘adequate liquidity’ that a CCP must have access to before it can start operating in the EU. Liquidity can come from both central banks and ‘creditworthy and reliable’ commercial banks;
- The level of capital, retained earnings and reserves of a CCP;
- The hypothetical ‘extreme market conditions’ that a CCP must take into account when it establishes the amount of its ‘default fund’ and of other emergency financial resources;
- The types of ‘highly liquid collateral’ that a CCP is allowed to accept to cover its exposure to its clearing members;
- The types of ‘highly liquid financial instruments’ in which a CCP is allowed to invest its financial resources.

It is sensible to have some of these rules treated as technical standards, with ESMA in charge. However, some of these standards are not technical at all, but a matter of policy. For example, the criterion for adequate liquidity and capital is akin to capital requirements for banks. It seems strange that ESMA would be allowed to decide these kinds of levels at its own discretion, when the equivalent standards for banks are always subject to rigorous and open debate amongst policymakers and regulators. As a counter-balance, member states do have the possibility to object to technical standards laid down by ESMA.

But clearly, there needs to be a more appropriate distinction between policy and technical standards in the proposal.

Regulation on short-selling and CDS

Under the proposed rules on short-selling and CDS, ESMA would be responsible for ensuring that a “consistent approach” is taken by national regulators on temporary bans on short-selling and CDS, although national regulators are allowed to ban short-selling unilaterally.³³

However, ESMA would also be allowed to impose temporary bans directly – a decision which would override any decision by national supervisors.³⁴

In addition, the Commission’s proposal also gives ESMA the power to set a number of technical standards, including the criteria for the notification of short positions; the

³³ http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_proposal_en.pdf (See page 33)

³⁴ *Ibidem*, page 36

method for assessing the principal venue for the trading of a share³⁵, and the method for calculating the 10% fall in value for shares and the specific fall in value for other financial instruments.³⁶

³⁵ These standards would be particularly relevant, since when the principal venue for the trading of certain shares is located outside the EU, those shares cannot be subject to bans under Commission's proposal.

³⁶ These standards could potentially also play a significant role, as the draft Regulation establishes that a remarkable fall in value allows national regulators to temporarily restrict short-selling of certain financial instruments

5. BENEFITS AND RISKS

Business as usual is clearly not a credible position following the worst financial meltdown in a generation. But the question is: will the new EU supervisors have the kind of positive impact its proponents hope for, for example in identifying risks, reducing uncertainty and mitigating the effect of a crisis once it hits? And what are the implications for financial markets and national regulators?

As it stands, the proposal is very much a mixed bag: some provisions have merits with a clear link to the financial crisis, other provisions are unnecessary, while others appear to be outright counterproductive.

5.1 Flow of information and host-home country resolutions

As the global financial crisis was inherently global in nature and received its main thrust from the US credit bubble and global economic imbalances, it is unlikely that the new supervisors would have had any significant impact on the events leading up to the Lehman default.

But a key lesson from the crisis is that regulators, central bankers and governments across the globe must learn how to exchange information and develop a better understanding of financial markets and instruments – as well as each other's actions and regulatory systems. The three new EU supervisors could provide a much needed forum (alongside the ESRB) for coordination and information exchange of this kind. This, in turn, could help regulators to better cope with innovations in the financial sector, i.e. new developments akin to the rise of 'shadow banking'.

It also makes sense to seek to clarify responsibilities and insurance arrangements in cases where the failure of an international bank, based in one country, exposes depositors and taxpayers in a different country to risks. In terms of EU supervision, this is what the Turner Review primarily was concerned with, for example. Giving the European Banking Authority, in particular, a role in mediating between national regulators and clarify the relationship between the host and the home country is therefore a sensible idea. Likewise, it is clear that credit rating agencies need to be subject to better regulation and supervision.

However, the creation of the three new EU supervisors also throws up a number of questions that should be causes for concern both for the City of London and the UK government.

5.2 Supervisory fudge can lead to uncertainty and contradictions

Splitting key supervisory powers between national and EU regulators risks creating more, not less, confusion about who exactly is responsible for overseeing the financial markets, who makes decisions and, crucially, where accountability lies.

Ambiguity over where ultimate responsibility lies has often been identified as one of the key failures in the UK's 'tripartite' regulatory system. As the Treasury has pointed out,

“Perhaps the most obvious failing of the UK system [...] is the fact that no single institution has the responsibility, authority or powers to monitor the system as a

whole, identify potentially destabilising trends, and respond to them with concerted action.”³⁷

The UK coalition government is now trying to address these flaws through its reforms of domestic financial supervision and the creation of the Prudential Regulatory Authority. But the risk is that the UK is repeating past mistakes by signing up to a supranational structure which creates more supervisory fudge in many areas.³⁸

For example, within the new EU structure uncertainty can arise over diverging interpretations of whether a decision by the EU supervisors has “a significant or material fiscal impact” on a member state (the term is hugely ambiguous after all). Appeals against a decision by the supervisor, or even discussions about appeals, could raise questions about who bears ultimate responsibility for taking necessary “concerted action”. Instead of having a calming effect, such lack of clarity about who is in charge could add to investor uncertainty and public anxiety, and therefore exacerbate market turmoil.

Confusion over the division of labour between different supervisors could also prevent national authorities from taking action. As Stuart Popham and Simon Gleeson of Clifford Chase LLP told the Commons Treasury Select Committee:

“There is no public material which indicates how an ESA would use this power, in what cases or to what end. It is also unclear whether and to what extent such a ‘declaration of emergency’ could inhibit national regulators from taking immediate steps. Given that it is very unlikely that an ESA will be able to act promptly or without notice (this is not a criticism, but a necessary consequence of the EU-wide composition of these agencies), there is a real risk that this power may have a chilling effect on national regulators considering action to address financial turbulence”.³⁹

As German think-tank Centrum für Europäische Politik has pointed out, “In times of crisis such a waste of valuable time could have disastrous effects”.⁴⁰

The merits of giving the EU supervisors such powers, particularly in an emergency, are therefore not obvious.

5.3 Breaking the link between supervision and fiscal authority

The fudge described above is also concerning as it highlights how the new structure breaks the link between the supervisor with the final say (the EU bodies in some cases) and the lender of last resort (national governments and central banks).

³⁷ HM Treasury, “A new approach to financial regulation: judgement, focus and stability”, July 2010

http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf

³⁸ A point made forcefully by former MP David Heathcoat-Amory for example, see <http://www.parliament.the-stationery-office.co.uk/pa/cm200809/cmhansrd/cm091110/halltext/91110h0001.htm>

³⁹ See the House of Commons Treasury Committee’s report on the proposals for European financial supervision, 11 November 2009

<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/1088/108807.htm>

⁴⁰ Centrum für Europäische Politik, “EU Banking Authority (EBA)”, 11 January 2010

As the FSA, and many others, have pointed out, the “intellectually pure” approach to supervision would involve having fiscal responsibility and supervisory authority placed at the same level, i.e. either at the EU or the national level. However, there has been no clear support for either approach. The European Parliament pushed for a pre-funded EU deposit insurance scheme – designed primarily to mitigate the impact of failures of cross-border banks – but this was shut down by national governments.

What we are left with is a half-way house which still leaves the question open as to what extent decisions by the EU supervisors ultimately will have to be underwritten by national governments’ budgets – as the “fiscal safeguard” provision in the proposal is very much open to interpretation (see below). More to the point, it raises the question whether the EU supervisors will be effective in a crisis, since their mandate to take strong action is dubious, at best. The crisis taught us that a strong mandate for regulators to act is essential when markets deteriorate – and that such a mandate must involve the ability to put up cash.

This goes beyond possible failures of retail banks (for which the supervisors’ mediation powers could help). For example, as we noted above, the Commission has tabled proposals which would give ESMA the power to authorise CCPs in OTC trades, and to determine which contracts need to be subject to clearing. However, should one of the parties fail, fiscal responsibility will rest with the member states in which the CCP is established.⁴¹

The question is whether this mis-match is healthy in the long-run.

Alternatively, the establishment of the European Banking Authority could be accompanied by an EU-wide deposit scheme. Indeed, the most recent compromise proposal (on the EBA) instructs the Commission to re-consider a “European Resolution Fund” for banks in three years’ time.⁴² A declaration from the European Commission annexed to the latest draft states that,

“These arrangements are a first step and would be reviewed by 2014 with the aim of creating Union integrated crisis management and supervisory arrangements, as well as a Union Resolution Fund in the longer term”.

The UK and other member states are likely to come under increasing pressure to accept an EU-wide resolution fund. Such a fund would serve to align supervision and fiscal authority – and could contribute to the EBA becoming more effective in managing and resolving future crisis.

But it also creates a number of fresh problems. Most importantly, establishing a pre-funded scheme at the EU level would increase the risk of moral hazard and irresponsible behaviour by banks. The UK is likely to continue to resist moves towards an EU-wide deposit scheme.

⁴¹ This point was made by Barney Reynolds, partner at the law firm Shearman & Sterling. See *FT*, “Brussels set to give way on OTC derivatives”, 1 September 2010.

⁴² <http://register.consilium.europa.eu/pdf/en/10/st13/st13070.en10.pdf> (see page 58)

5.4 The “fiscal safeguards” are not watertight

The above also highlights how it is virtually impossible to guarantee that decisions taken by the EU supervisors will have *no* impact on national budgets.

The House of Commons Treasury Select Committee last year recommended that the UK did not sign up to the proposals until it provided “proper protection for the fiscal position of Member States” and “until the fiscal sovereignty of the UK is protected by a veto.” However, the proposal is now being endorsed without the UK and other member states having been given an unambiguous veto.

The safeguard clause in the proposal applies when the supervisors act in emergency situations (Article 10) or settle disputes between national regulators (Article 11). For other decisions, such as how EU law should be applied or bans on financial products, member states would be left without any safeguards (fiscal or otherwise).

For Articles 10 and 11, a “triple-lock” will work as follows:

- Member States can submit an official complaint to the Council of Ministers ;
- The Council will need a simple majority to revoke the supervisor’s decision, otherwise the decision stands;
- Member States can request the Council to re-examine their complaints in case simple majority is not achieved at first voting.

This is clearly an important safeguard – but it is not a veto. Indeed, when in opposition Mark Hoban, now City Minister, criticised the then Chancellor Alistair Darling for having caved in on the veto when the idea for a triple-lock was first agreed last December. Mr. Hoban said,

“Does the Government have a veto over any decisions made by the ESA in an emergency that have a fiscal impact on Britain, or do they have to make an appeal against these decisions? This is another example of the Government failing to stick to its red lines [...] It is clear that they can now make binding decisions which could have a fiscal impact but all that national governments can do is to appeal against these decisions.”⁴³

Since then, the proposal has added a paragraph further weakening the appeal procedure, by explicitly prohibiting the use of the “triple-lock” against a decision that does not have “a significant or material fiscal impact”.⁴⁴ As German MEP Sven Giegold – the European Parliament’s rapporteur for ESMA – has pointed out, member states will have the right of appeal only “when there is a significant impact on the expenditure side of national budgets”.⁴⁵

⁴³ Quoted in the *Daily Telegraph*, “Alistair Darling loses EU fight over fiscal sovereignty”, 2 December 2009, see <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6712062/Alistair-Darling-loses-EU-fight-over-fiscal-sovereignty.html>

⁴⁴ <http://register.consilium.europa.eu/pdf/en/10/st11/st11963-re01.en10.pdf> (see page 16)

⁴⁵ *WSJ*, ‘EU financial rules delayed’, 14 July 2010 <http://online.wsj.com/article/SB10001424052748704220704575367293273858992.html?KEYWORDS=mattnew%2520dalton>

This appears to create a conflict within the proposal itself, as paragraph 1 of Article 23, provides that “no decisions adopted under Articles 10 and 11 [shall impinge] in any way on the fiscal responsibilities of member States”.

This ambiguity could lead not only to uncertainty in times of crisis, as argued above, but it also raises questions about democratic control, as taxpayers in member states would have no apparent way to hold the new supervisors to account.

5.5 The risk of hijack

The combination of simple majority to reach decisions within the supervisors (as a rule), the absence of clearly defined competencies for the new bodies (as new directives can fall under the ESAs’ authority at any given time), and the lack of democratic control leaves virtually no safeguard in place to ensure that these new bodies are not hijacked by narrow agendas – whether political or commercial.

For example, the proposal only states that the supervisors can take actions or ban products “in the case of adverse developments which may seriously jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the European Union.”

No definition exists of what “adverse developments” actually means, and there are no indications of how the ESAs would use the emergency powers, or to what end. Crucially, the supervisors will have the mandate to issue bans or restrictions *without* an emergency situation having to be called by the Council of Ministers. The supervisors only need to consider the “orderly function of the markets” to be under threat and they can decide to take actions following a simple majority vote (in which the UK will control only 3.7 percent of the votes).⁴⁶

There are instances where an EU-wide approach to restrictions is appropriate. But the recent ban on short-selling in Germany – allegedly in response to the sovereign debt crisis – ought to give an indication of how such measures stand the risk of being driven by politics rather than economic reality or long-term thinking. This, in turn, can have a hugely negative impact on market stability, which the German short-selling ban indeed had. Poorly thought through bans or restrictions could also hurt the economy by, for example, leading to less liquidity in an economic downturn (by restricting fund managers for instance).

As the FSA has noted,

“We appreciate that there may be concern that powers of this sort could be abused and used for commercial or protectionist measures (rather than for market confidence or consumer protection reasons), and we are willing to debate how best to reduce the possibility of abuse, for example through the ability of home states to appeal to the ESA.”⁴⁷

⁴⁶ In cases where an emergency hasn’t been called, the Commission has to approve the ban before it enters into force.

⁴⁷ Response from the Financial Services Authority to the Treasury Select Committee report on Banking Crisis: Regulation and Supervision, see <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/1088/108804.htm>

However, there has not been much discussion about how to prevent such abuse and, at the moment, member states can only appeal a decision on “fiscal grounds” (apart from decisions on technical standards). Also, appeals against the supervisors’ decisions do not apply at all to bans on products or actions against firms which have failed to properly implement EU law.

Giving the supervisors the power to take such actions therefore opens up another avenue for arbitrary government action, something which could come back to haunt the UK – and the City – in future.

6.6 The single rulebook: the City will benefit if the UK writes it

The supervisors will also be given a mandate to interpret, apply and enforce Single Market regulation in a wide range of areas. This will primarily take place through the supervisors’ power to issue binding technical standards and address national regulators and firms that have not implemented EU laws properly (as interpreted by the supervisors).

The Labour Government and now the Coalition Government have argued that it is in the UK’s interest to have a “single rulebook” for the EU’s internal market, and have therefore welcomed extending such powers to the new EU bodies. For example, the UK’s City Minister, Mark Hoban, has said that the Coalition Government “supports strong ESA powers to ensure EU law is being followed and if necessary, to enforce it where this is found to be lacking.”⁴⁸

Also some industry organisations have welcomed the move, including the Investment Managers’ Association which has argued:

“A harmonised regulatory and supervisory framework is therefore of great importance to the industry: it is very expensive and inefficient to operate under 27 different sets of rules, or 27 differing interpretations of the EU rules. In too many areas of financial markets regulation, and especially supervision, national differences remain strong beneath a veneer of European harmonisation.”

This is true. City firms could benefit from more consistent application of EU law, for example through the removal of national barriers to market access across the bloc (e.g. under the UCITS IV Directive).

However, this assumes that the rulebook will always be written according to the City’s or the UK’s preferences and demands. This is a heroic assumption as decisions within the supervisors on technical standards will be taken by QMV and decisions on implementation of EU law will be taken by simple majority. This puts the UK in a weak position to push through its version of the Single Market in financial services and resist protectionist interests.

There are many examples in the history of EU financial regulation of when the UK has been outvoted or forced to accept sub-optimal legislation. The AIFM Directive, most

⁴⁸ Speech given by Mark Hoban at the Bruegel think-tank in Brussels on 2 September 2010, “The UK’s Approach to European, Global and Domestic Financial Regulation”
http://www.hm-treasury.gov.uk/speech_fst_020610.htm

recently, had very little logic behind it - apart from purely political - when it was tabled last year, but the UK will be forced to accept large chunks of it (although possibly in a considerably less damaging form than what was originally envisioned).⁴⁹

In other words, there is a trade-off here – the opportunity lies in the stronger mechanism to stamp out unhealthy gold-plating or diverging implementation of directives. The risk is that the City is now exposed to one more channel of government intervention, decided in a forum where the UK is only one of 27 voices, many of which take a different view to the UK on financial markets.

The lines between what constitutes technical standards, implementing standards (where the ESA can issue binding decisions) and policy (where they cannot) are also very ambiguous in the proposal, making it far from clear where the ESAs' powers over the Single Market begin and end.

As William Underhill, Chairman of the City of London Law Society's Company Law Committee, pointed out at an Open Europe debate:

“What are the boundaries of the single EU rulebook that lies behind a lot of this new architecture? [...] The assumption is that the single rulebook in all circumstances justifies the change, whereas I think we still need to look at each specific proposal, each technical standard that comes forward needs to be justified against more subsidiarity principles.”

The trade-off created by granting the supervisors single market powers has been subject to virtually no scrutiny leading up to the adoption of this proposal.

⁴⁹ See *Open Europe*, “The EU's AIFM Directive: Likely Impact and Best Way Forward”, 21 September 2009 <http://www.openeurope.org.uk/research/aifmd.pdf>

ANNEX I: HOW WILL ESA'S POWERS OVER NATIONAL AUTHORITIES WORK?

Emergency powers

Power to intervene directly in emergency situations

Under the most recent compromise proposal tabled by the EU Presidency (2 September):

- The Council determines the existence of an emergency situation following consultations with the Commission, the ESRB and the EU supervisors
- The European Parliament is formally empowered to request the Council to call an emergency⁵⁰
- The Council takes its final decision by QMV or simple majority, meaning that member states will not be able to veto it in any case
- The EU supervisor then adopts a decision addressed to national supervisors. The decision will be aimed at “mitigating risks which jeopardise the orderly functioning of the market and the stability of the entire or part of the financial system”. It will be taken by simple majority within the Board of Supervisors
- EU supervisors can address individual financial institutions directly if national authorities do not comply with their decisions
- Member states can appeal an “emergency decision” to the Council of Ministers if they consider that the decision infringes on their fiscal sovereignty in a “significant or material” way – i.e. if it has a significant impact on the expenditure side of national budgets⁵¹
- The safeguard for member states is much softer than the original one, which established that “emergency decisions” should not impinge “in any way” on member states’ fiscal responsibilities⁵² and did not have a clause specifying that member states are not allowed to “abuse” the appeal procedure⁵³
- A simple majority is needed within the Council to overturn decisions from EU supervisors
- In case the measure is maintained, member states can ask the Council to re-examine the matter. It is not clear what happens after that. However, member states will have no absolute veto over decisions taken by the ESA

Power to ban “toxic” products

- EU supervisors will have the power to impose temporary bans on “toxic” financial products and activities – possibly including CDS activities or short-selling – if they

⁵⁰ *European Parliament*, “MEPs secure overhaul of EU financial regulation”, 2 September 2010
http://www.europarl.europa.eu/news/public/story_page/042-80931-252-09-37-907-20100902STO80930-2010-09-09-2010/default_en.htm

⁵¹ *WSJ*, “Disagreement delays new EU financial rules”, 15 July 2010

<http://online.wsj.com/article/SB40001424052748704220704575367293273858992.html>

⁵² See for instance

http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_503_en.pdf
(page 35)

⁵³ See Article 23(4) of the latest compromise proposal tabled by the EU Presidency
<http://register.consilium.europa.eu/pdf/en/10/st13/st13070.en10.pdf> (page 72)

are thought to be putting at risk “the orderly functioning and integrity of financial markets” within the EU⁵⁴

- Bans are very likely to be decided by simple majority within the Board of Supervisors⁵⁵, meaning that national regulators will have no veto power over such decisions
- Crucially, the use of this power will not be restricted only to “emergency situations” and would therefore be in addition to the ESAs’ emergency powers⁵⁶
- However, outside of “emergency situations”, the bans will need the approval of the Commission⁵⁷
- The bans would be temporary and would automatically expire unless the EU supervisors renew their decisions at least every three months (according to the Council’s most recent proposal tabled on 2 September)⁵⁸
- Member states would not be allowed to appeal bans imposed by the EU supervisor⁵⁹

Crisis prevention and management powers

Power to settle disputes between national regulators

- If national authorities fail to settle a dispute arising in an area falling within the competences of the ESA, the latter have the mandate to solve the matter with a binding decision. The decision will be taken by simple majority within the Board of Supervisors⁶⁰
- Following pressure from the European Parliament, the latest compromise proposal tabled by the EU Presidency gives the EU supervisors the right to intervene in disputes on their own initiative⁶¹
- If national regulators do not comply with the rulings, EU supervisors are authorised to impose individual decisions directly on the financial institutions involved in the dispute – for example banning a certain activity
- Member states can appeal a ruling to the Council of Ministers through a procedure similar to the one described above with regard to “emergency decisions”, but will not have the power to veto a decision from the EU supervisors

⁵⁴ <http://register.consilium.europa.eu/pdf/en/10/st13/st13070.en10.pdf> (see page 34)

⁵⁵ The power to prohibit dangerous financial activities in Article 6 provides no exception to the general rule on decision-making established by Article 29 of the proposals

⁵⁶ See article 6a(5) of the latest EU Presidency’s compromise proposal
<http://register.consilium.europa.eu/pdf/en/10/st13/st13070.en10.pdf> (page 34)

⁵⁷ *Handelsblatt*, “EU bekommt mächtige zentrale Finanzaufsicht”, 2 September 2010
<http://www.handelsblatt.com/politik/international/neue-befugnisse-eu-bekommt-maechtige-zentrale-finanzaufsicht;2647076>

⁵⁸ <http://register.consilium.europa.eu/pdf/en/10/st13/st13070.en10.pdf> (see page 34)

⁵⁹ Article 6 is not covered by the safeguard clause outlined in Article 23 of the proposals

⁶⁰ Article 29(1) of the latest compromise proposal tabled by the EU Presidency has introduced an exception to EU supervisors’ dispute settlement powers, establishing that when the controversy between national regulators originates from a decision taken by a national regulator acting as a “consolidating supervisor”, the ruling can be rejected by a blocking minority within the Board of Supervisors. A national regulator acts as a “consolidating supervisor” when it oversees a financial conglomerate – the so-called “parent company” – in its entirety, i.e. including its branches located abroad, see p. 81 in
<http://register.consilium.europa.eu/pdf/en/10/st12/st12457.en10.pdf>

⁶¹ The compromise proposal tabled by the Belgian Presidency and agreed by ECOFIN on 13 July 2010, contains such a provision <http://register.consilium.europa.eu/pdf/en/10/st11/st11963-re03.en10.pdf> (see page 5). The provision has been maintained in the latest compromise proposal published on 2 September 2010 <http://register.consilium.europa.eu/pdf/en/10/st13/st13070.en10.pdf> (page 50)

Exclusive supervisory powers over credit rating agencies (ESMA only)

In June, the European Commission tabled a separate regulation giving ESMA exclusive supervisory powers over credit rating agencies operating within the EU⁶².

Under the Commission's proposal:

- All the credit rating agencies wishing to provide their services within the territory of EU member states will have to submit to ESMA an application for registration;
- ESMA will be entitled to ask for more information at any time, conduct investigations and perform on-site inspections, without the approval of national supervisors
- To this end, member states are obliged to provide ESMA officials with "the necessary assistance, requesting where appropriate the assistance of the police or of an equivalent enforcement authority, so as to enable them to conduct their on-site inspections"⁶³
- In the event of infringements of EU law by one or more credit rating agencies, ESMA will have at its disposal a wide range of sanctions – including occasional fines, periodic penalty payments⁶⁴, temporary prohibitions from issuing credit ratings and withdrawal of the registration (meaning an outright ban from operating within the EU)
- Should it enter into force, the regulation on credit rating agencies would make ESMA the first pan-EU regulator with exclusive supervisory powers

Single Market powers

Power to issue binding technical standards

- EU supervisors will have the power to set up binding technical standards in a range of different areas, with a view to creating a "single rulebook" for the EU's Internal Market
- These new common rules should not "imply strategic decisions or policy choices"⁶⁵
- Technical standards have been divided by the Council into two categories: regulatory technical standards and implementing technical standards
- The Commission will need a mandate by the Council and the European Parliament before EU supervisors can start drafting regulatory technical standards. No delegation will be required to issue implementing technical standards⁶⁶
- Technical standards will be adopted by QMV within the Board of Supervisors and will have to be signed-off by the European Commission before they can enter into force
- Once the Commission has endorsed a new regulatory technical standard, the Council and the European Parliament have between one month and three months to object to the decision before it is published in the EU's Official Journal⁶⁷

⁶² http://ec.europa.eu/internal_market/securities/docs/agencies/100602_proposal_en.pdf

⁶³ http://ec.europa.eu/internal_market/securities/docs/agencies/100602_proposal_en.pdf (see page 23)

⁶⁴ In these first two cases, it is the European Commission that formally imposes the sanctions following ESMA's requests

⁶⁵ http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_503_en.pdf (see page 25)

⁶⁶ <http://register.consilium.europa.eu/pdf/en/10/st12/st12457.en10.pdf> (see page 39)

⁶⁷ <http://register.consilium.europa.eu/pdf/en/10/st12/st12457.en10.pdf> (page 40)

- If the Council or the European Parliament objects to a regulatory technical standard, it does not enter into force

Power to intervene directly against firms breaching EU law

- EU supervisors will be entitled to take action against firms and national regulators that breach EU rules⁶⁸ or fail to ensure their correct implementation
- If EU supervisors believe that one or more national authorities are not applying EU law correctly, they can conduct investigations on their own initiative
- EU supervisors can then decide to issue a “recommendation” addressed to a national regulator
- If national authorities fail to comply with these recommendations, the Commission steps in and gives its formal opinion⁶⁹
- In case the non-compliance persists after the Commission’s intervention, the ESAs are automatically authorised to adopt binding decisions addressed to single financial institutions and oblige them to cease or change a practice
- These measures will be taken by simple majority within the Board of Supervisors
- Crucially, the proposals as they stand do not allow member states to appeal to the “safeguard clause” mentioned above, even if the decisions have an impact on their fiscal responsibilities⁷⁰

Power to issue guidelines and recommendations

- EU supervisors will be allowed to issue guidelines and recommendations addressed to national supervisors “with a view [...] to ensuring the common, uniform and consistent application” of EU legislation⁷¹
- Guidelines and recommendations will be adopted by QMV within the Board of Supervisors
- Although they are not legally binding, national regulators and financial institutions “shall make every effort to comply with those guidelines and recommendations”⁷²
- This provision seems to be giving the ESAs quasi-legislative powers

Power to coordinate peer reviews between national supervisors

- EU supervisors will be entitled to “organise and conduct peer review analyses of some or all of the activities” of national supervisors
- The review will be primarily aimed at testing the degree of convergence achieved in the application of EU law⁷³
- On the basis of the peer review, EU supervisors can issue guidelines and recommendations which national authorities will have “to make every effort” to comply with

⁶⁸ Including technical standards

⁶⁹ <http://register.consilium.europa.eu/pdf/en/10/st13/st13070.en10.pdf> (see page 46)

⁷⁰ Decisions concerning infringements of EU law will be taken under Article 9 of the regulation, which is not covered by the “safeguard clause” outlined in Article 23

⁷¹ <http://register.consilium.europa.eu/pdf/en/10/st13/st13070.en10.pdf> (see page 44)

⁷² Ibidem

⁷³ <http://register.consilium.europa.eu/pdf/en/10/st12/st12457.en10.pdf> (page 63)

ANNEX II: DIRECTIVES UNDER ESAS' CONTROL

Directive 94/19/EC on deposit-guarantee schemes / Directive .../.../... on deposit-guarantee schemes [recast] – **EBA**

Directive 97/9/EC on investor-compensation schemes – **ESMA**

Directive 98/26/EC on settlement finality in payment and securities settlement systems – **ESMA**

Directive 2001/34/EC on the admission of securities to official stock-exchange listing and on information to be published on those securities – **ESMA**

Directive 2002/47/EC on financial collateral arrangements – **ESMA**

Directive 2002/65/EC concerning the distance marketing of consumer financial services – **EBA, ESMA and EIOPA**

Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate – **EBA, ESMA and EIOPA**

Directive 2002/92/EC on insurance mediation – **EIOPA**

Directive 2003/6/EC on insider dealing and market manipulation (market abuse) – **ESMA**

Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision – **EIOPA**

Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading – **ESMA**

Directive 2004/39/EC on markets in financial instruments – **ESMA**

Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market – **ESMA**

Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing – **EBA, ESMA and EIOPA**

Directive 2006/48/EC on the taking-up and pursuit of the business of credit institutions – **EBA**

Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions – **EBA and ESMA**

Directive 2007/64/EC on payment services in the internal market – **EBA**

Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) – **ESMA**

Directive 2009/110/EC on the taking-up, pursuit and prudential supervision of the business of electronic money institutions – **EBA**

Directive 2009/138/EC on the taking-up and pursuit of the business of insurance and re-insurance (Solvency II) – **EIOPA**

In the pipeline:

Regulation .../.../... amending Regulation 2009/1060/EC on credit rating agencies – **ESMA**

Directive .../.../... on Alternative Investment Fund Managers – **ESMA**

Regulation .../.../... on OTC derivatives, central counterparties and trade repositories – **ESMA**

Regulation .../.../... on Short Selling and certain aspects of Credit Default Swaps – **ESMA**