European Shadow Financial Regulatory Committee

Statement No. 10

Madrid, 26 March 2001

THE REGULATION OF EUROPEAN SECURITIES MARKETS: THE LAMFALUSSY REPORT

The introduction of the single currency is creating pressure for common standards of financial regulation, especially with regard to securities markets. Compared to the United States, European capital markets appear to be too small, insufficiently competitive and excessively fragmented. Progress towards a single market in financial services is hindered by the existence of fifteen different national systems of financial legislation and by slow and rigid European Community procedures. The Lamfalussy Report,[1] i.e., the Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, published on 15 February 2001, now adopted by the European Council in Stockholm on 23 March, presents a useful diagnosis of the issues and problems. At the core of these concerns lie the difficulties of implementing reforms through national regulators who, given their inherent risk aversion reinforced by their accountability to national policy makers, have a tendency to exploit any ambiguities in EU Directives in favour of national exchanges and constituencies. The issue is whether the new proposals meet the challenge of overcoming inertia.

In this statement, the European Shadow Financial Regulatory Committee identifies the following shortcomings in the Report:

- It is unlikely to achieve its objectives within the stated time frame.
  - Its key procedures are unnecessarily cumbersome.
  - Political and institutional gridlock is a serious concern.

In order to remedy these shortcomings we recommend the following:

  - A simplified legislative procedure involving one rather than two securities committees.
- Accountability to the European Parliament must be a central feature of this legislative process, including level 2.
  - There should be increased reliance on market forces and self regulation.

The Recommendations of the Lamfalussy Report

The Report proposes a four-level regulatory approach. Level 1 refers to EU framework legislation and involves the EU Commission, Council and Parliament. Level 2 refers to EU implementation and involves in addition to the EU Commission a European Securities Committee (ESC) and a European Securities Regulators Committee (ESRC), both yet to be created. Level 3 refers to national implementation and co-operation and involves the ESRC and the Member States. Level 4 refers to enforcement and involves the Commission and the Member States. The Report states that the proposed ESC would be set up following the regulatory 'comitology' procedure suggested for implementing powers conferred on the Commission. It would be composed of high-ranking officials – State Secretaries in the Finance Ministries of the Member States or their personal representatives – and would be chaired by the European Commissioner responsible for the Internal Market in Financial Services. The ESRC would be set up as an independent advisory group to the Commission (outside the comitology process) and would be composed of national securities regulators.

Assessment of the Lamfalussy Report

We regard the four-level regulatory approach proposed in the Report as cumbersome and complicated, in particular because of the proposal to create two new committees. Whereas the goal of the Report is to speed up EU financial regulation, it appears that level 2 with its five-step procedure may actually slow it. We do not find that a convincing case has been made for establishing the high-level ESC.

We suggest that only one securities committee be established composed of national securities regulators.

Mutual suspicion among national and European institutions has complicated the enactment of financial legislation in the EU. Criticism of the framework has come, in particular, from the European Parliament (EP) which on 14 March by 410 to 25 voted in favour of an appeals procedure or "call back" that would enable the EP to review and halt legislation proposed at level two beyond the scope in the Lamfalussy Report. This accords the EP such a right only if the proposal goes beyond the implementing powers ("ultra vires") of the Commission and the ESC. To extend the EP's power to call back a proposal on substantive grounds is seen by the Council and the Commission as setting a dangerous precedent for parliamentary involvement and as a recipe for slowing down the adoption of new proposals. The EP has been promised it will be kept fully informed of proposals developed at level two, but the EP is concerned that it will be unable to exercise influence over the compromises struck between the Commission and the national authorities represented in the ESC and the ESRC. The EP's concern is highlighted by the press release of 23 March 2001, stating that "the ECOFIN resolution represents a useful agreement between two of the three institutions" but it does not yet take fully take into account the EP's concerns regarding "democratic procedures and transparency."

The concerns of the EP appear to be shared by a number of market participants who foresee a lack of transparency in the final stages of preparing legislation at level two. While the national regulators in the ESRC will prepare their advice to the Commission in consultation with market participants, end-users and consumers, outside scrutiny will be cut off in the final stages of negotiation between the Commission and the national governments represented in the ESC.

Keeping also this final stage transparent through monitoring by the EP may slow down an already cumbersome process, but could also improve the quality of the legislative output. In the absence of willingness of the European Council to give the EP – and through it the expertise of market participants – monitoring powers over implementation of legislation at level 2, the co-operation of the EP in the full co-decision procedures at level 1 could prove difficult to ensure. That would imply an even greater potential for delay and probably an end to the ambition to have the new framework operational in the near term.

Since attempts to by-pass scrutiny by the European Parliament would in our view be counterproductive and invite political gridlock, we recommend that the EP is explicitly involved in the level 2 regulatory process.

Doubts have also arisen whether Member States are prepared to respect the right of initiative of the Commission in proposing legislation. Some Member States insisted that the Commission in formulating its proposals should be bound by a majority in the advisory bodies of high officials and national regulators. This conflict now appears to have been papered over by skilful drafting. But the discussion in Stockholm confirms that national governments remain very reluctant to cede power to either of the two institutions – the EP and the Commission[2] – with a transnational mandate to enact harmonised rules for the integration of Europe's capital markets. Increased interference by the national governments would threaten to slow down the rule-making process to the detriment of market integration.

In one respect, the reluctance in the Council to see the influence of the EP and the Commission enhanced is understandable. Most of the expertise in the area of financial regulation is today found in national regulatory agencies – and, of course, in the financial institutions affected by the legislation. Accordingly, there is a need to allocate greater human resources to the staffing of both the Commission and the EP.

The focus on procedures should not be allowed to obscure the importance of inter-market competition as a means of securing greater integration of European securities markets. To ensure that market forces are not impeded by national authorities using existing loopholes in directives to restrict competition we recommend the following steps:

1. *The Investment Services Directive should be revised to close existing loopholes that allow national authorities to discriminate against foreign exchanges.*

2. *Increased emphasis should be placed on the foundations for functioning market competition in the form of common accounting standards and disclosure rules*.

In its statement of June 2000, the European Shadow Financial Regulatory Committee proposed specific reforms of the ISD with a view to promoting competition between exchanges. These covered issues such as the 'regulated markets' concept in the ISD, de-linking listing and trading, and the authorisation of 'new markets.' Given the political will these recommendations should be implemented in the near term.

The Longer Term Perspective

In a longer term perspective the two major issues at stake are on the one hand, the creation of a single European securities regulator and, on the other, the adoption of basic standards of European securities regulation. The Lamfalussy Report stops short of proposing the former (though leaves the door open through a fall back remark)[3] and calls for the reform of the Investment Services Directive (ISD) and the prompt adoption of other measures included in the Commission's Financial Services Action Plan. The European Shadow Financial Regulatory Committee has already made a case for the limited reform of the ISD. We regard common standards as an essential element of a single financial market. But the main thrust of the Lamfalussy Report is about processes and legal procedures to reform securities markets.

The real conundrum is whether we should have at all a single securities regulatory agency in Europe, and if so, the scope of powers that it should have (an issue which exceeds the scope of this statement). Should it be modelled as a super Financial Services Authority (FSA) or as a European version of the US Securities and Exchange Commission (SEC)? The creation of the FSA in the United Kingdom and the proposed establishment of such an agency in Germany suggest a supervisory trend towards consolidation. However, if the FSA has often been criticised as a 'regulatory Leviathan' and accountability remains a major concern, a European FSA would be far too powerful to be acceptable to politicians across Europe. Thus, if a centralised agency is to be created, it is likely to be a European SEC rather than a European FSA.[4] But the Lamfalussy Report on page 41 (see footnote 3) suggests that a "single EU financial regulatory authority for financial services generally" may be created.

We believe that with regard to this last point, the Lamfalussy Report is open to criticism. The creation of such an authority may be the natural outcome of a successful integration of European financial markets over time. However, it should not be introduced as a default measure in response to the failure of the proposed new procedures.

The European Shadow Financial Regulatory Committee is a group of academics and other experts whose mission is to follow and analyse critically the existing and evolving regulatory framework for financial markets. The Committee gratefully acknowledges financial support by PricewaterhouseCoopers. However, the Committee is fully independent and autonomous in drafting its statements.

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[1] See http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussy.htm

[2] According to the Resolution of the European Council in Stockholm: "The European Council notes that within the framework of the comitology decision of 28 June 1999, the Commission has committed itself, in order to find a balanced solution for those cases of implementing measures in the field of securities markets acknowledged in the light of the discussions to be particularly sensitive, to avoid going against predominant views which might emerge within the Council, as to the appropriateness of such measures. This commitment shall not constitute a precedent."

[3] "[…]If the full review were to confirm in 2004 (or earlier as the case may be) that the approach did not appear to have any prospect of success, it might be appropriate to consider a Treaty change, including

the creation of a single EU regulatory authority for financial services generally in the Community." Lamfalussy Report at p. 41.

[4] The creation of such an agency may also prompt the transfer of prudential supervisory responsibilities – over credit institutions – from the national level to the European Central Bank level (Article 105.6 of the EC Treaty).