International Securities Market Association
International Primary Market Association
Association of Norwegian Stockbroking Companies
Bankers and Securities Dealers Association of Iceland
Danish Securities Dealers Association
Finnish Association of Securities Dealers
London Investment Banking Association
Swedish Securities Dealers Association
The Bond Market Association

Response to CESR's consultation on its October 2004 Preliminary Progress Report "Which Supervisory Tools for the EU Securities Markets?"

The "Himalaya" Report

31st January 2005

General comments

1. There is much in the Report with which we agree. In particular, we welcome CESR's emphasis on achieving its core objective of ensuring more consistent and convergent application of laws in the securities field under the Financial Services Action Plan ("FSAP"), using the cooperative approach envisaged by the Lamfalussy report.

2. It is important to do so, and to encourage trust and cooperation between national regulators, in a way that is consistent with both the full implementation of the Lamfalussy process, and the national accountability of CESR members.

3. We have the following general comments, on which we elaborate in our detailed comments on CESR's Report below.

(a) We share CESR's view that there has been considerable progress under the Lamfalussy approach to create a solid legal basis for a single market in financial services as well as for enhanced convergence in supervisory practices under the FSAP. We recognise the important role which CESR has played in that process. We also agree that there is considerable scope within the current framework to develop and enhance cooperation, and we applaud CESR's initiative in consulting about tools to achieve this objective. However, we consider that it is still too early for CESR to begin seeking to identify where it wishes to move away from the Lamfalussy approach by making significant adaptations to the current supervisory arrangements or the Lamfalussy report or creating new institutions or EU-level decision-making mechanisms. In any event, there should be no presumption as to the role played by any particular entity in any future mechanisms. The appropriate approach will depend on the circumstances.

(b) We agree that fragmented or inadequate national supervisory arrangements could undermine the co-operative arrangements envisaged by the FSAP directives. That said, in our view it would be necessary to identify a failure which must be rectified before proposing far-reaching and resource-intensive changes. In the absence of such a failure, it is not necessary, we believe, for all national regulators to have exactly the same capacity to act for the current arrangements to work satisfactorily. For example, different national approaches to divisions of responsibility with respect to the supervision of takeovers need not be incompatible with further successful integration of the single market. In any event, the implementation of the Market Abuse Directive ("MAD") and the Directive on Markets in Financial Instruments ("MIFID") will address some of the issues about differences of powers. We consider that CESR should, consistently with the principle of subsidiarity and CESR's recognition of the need to take account of the diversity of markets, and of the need for them to develop at their own speed, recognise that in the absence of identified failure the existing legislative arrangements provide an appropriate basis for mutual recognition. We suggest that a better approach than 'equal supervisory intensity' and harmonisation of powers would be to focus on equivalence of supervisory effectiveness, measured against agreed overarching objectives of regulation. This approach would help to identify where there may be a case for adjustments to national competences and powers, where it can be shown that the current alignment actually does interfere with the ability of competent authorities to cooperate, or with the effectiveness of the supervisory arrangements.

(c) We agree that there should be continued and greater convergence between supervisory approaches and appropriate calibration of regulatory approaches. We stress the need for transparency of supervisory practices. However, we consider that regulation should focus on cases where there is demonstrable market failure and where the benefits of regulatory action clearly outweigh the costs of intervention. Seeking to build investor confidence across the EU, a goal we fully support, simply by giving primacy to uncosted and untested regulatory action, seems likely to generate ever more extensive and intrusive regulation which would constrain market development.

(d) In particular, we consider that there should be a significantly less intensive regulatory approach to wholesale markets where market participants are better able to protect their own interests.

(e) We would be concerned if CESR sought a controlling role for itself which would inappropriately override bilateral liaison and cooperation between CESR members. We would also be concerned if CESR sought to play a role in individual supervisory cases, whether in handling enforcement action or in making individual supervisory decisions. Supervision and decision-making with respect to individual firms or institutions should remain with the individual competent authorities to which those firms or institutions are subject, either on a bilateral or multilateral basis. There is a particular need to avoid prejudicing the confidentiality of information. The Directives and national laws impose strict obligations of professional secrecy which only allow sharing of confidential information with other national competent authorities in limited circumstances. Additionally, there are cooperation arrangements specified in directives such as the Financial Groups Directive which must not be overlooked in these cases.

(f) We are also concerned by the suggestion that there is a need for CESR to play a role in the "pre-clearance" of products or services, in particular as MIFID enshrines a home state/country of origin approach in which firms should not need further host state approvals for cross-border activity. We do not think that any of CESR's examples of possible areas for "single EU decision" really represent cases where the currently envisaged mechanisms are likely to fail. Indeed, we question whether it is appropriate for CESR to presume, at this stage, that they will prove inadequate in the ways indicated.

(g) We also consider that greater emphasis needs to be given to developing common approaches with the Committee of European Banking Supervisors (CEBS). CESR states that its work “does not cover issues related to prudential supervision of banks”. This may in principle be true, but in practice it is not clear that one issue can be considered separately from the other unless there is clarity on how the prudential regulation of investment firms (which are subject to the same framework as banks) is to be treated. In many cases, it is not practical readily to separate the prudential supervision of banks from other issues, as recent divergent approaches on outsourcing show.

(h) We recognise that much has been achieved in improving the consultation process on new proposals. However, we consider that in future there should be greater scope for publishing full analyses of the current legal and regulatory frameworks in individual member states and how the proposals would require changes (even if this is only practical for a sample out of 25 member states). We consider that the publication of this kind of analysis is a key next step towards realistic assessments of the potential impact of proposed measures and proper cost-benefit analysis, which has been lacking in the development of the FSAP to date. It would also serve to benchmark implementation measures, as it would indicate how any proposed measure is expected to change national rules.

4. We have seen, and support, ISDA’s response to the consultation.

Detailed comments on CESR’s Report

Executive Summary

Key Point 2. We generally support CESR’s proposed ‘adaptive’ strategy, but see our comments on the Main Paper below.

Key Point 3. We consider that only in extreme cases could Home-Host country relationships be damaged or sub-optimal if the powers and resources of the various supervisors are divergent. Complete consistency is less important than assessing whether any supervisor lacks any minimum necessary powers. CESR should focus on discrepancy of approach between regulators as a more serious obstacle to the success of Home-Host relationships. In the absence of specific failure to comply with EU law (which would be for the Commission to address) the domestic organisation of the competent authorities within a Member State will ultimately be for that State to determine.

Key Point 4. We do not agree that Level 3 suffers from democratic deficiency. In many circumstances it is preferable for supervisors to organise their practices themselves. Furthermore, it is important to recognise that supervisors must be accountable to national authorities who work within the international legal framework that is set up in a process of full democratic accountability. Equally it is essential to recognise that it would not be practical or desirable to submit every individual supervisory action to democratic scrutiny and legislative control. This would also not be consistent with any drive towards deregulation. The boundary between those acts that fall properly within the legislative sphere and those which have to be left to the determination of the supervisor in its exercise of judgement can be and is policed on a legislative basis. However, legislative intervention in Level 3 is not appropriate. Furthermore, while cooperation is the hallmark of CESR’s operations, it is also important to take account of the ESC’s statement at its meeting on 1st June 2004 that ‘Level 3 cannot produce mandatory rules at the EU level’. As stated in our earlier comments, we do not think it is appropriate at this stage for CESR to seek to enhance its authority at Level 3. CESR should continue to focus its efforts on mutual understanding and practical cooperation among its members.

Key Points 5 and 6. We agree with CESR that it is neither necessary nor desirable to consider trans-national options now or in the foreseeable future.

Main Paper

Introduction

Page 4:
We welcome CESR’s stress on basing its analysis on the needs of the markets. We also support its stress on not suggesting the creation of new institutions without a precise idea of what their role would be.

I) How integrated is the EU Securities Market?

Page 8:
We agree with CESR's view of the need for careful analysis of obstacles before deciding whether further legal changes are necessary.

As the post-FSAP Securities Experts Group Report identified, a further important supervisory tool that CESR should use at Level 3 is to identify where there is a need to amend or correct Level 2 or Level 1 legislation in the light of experience. A mechanism to identify deficient legislation, and notify the Commission of the need to remedy it, will be crucial to the effectiveness of CESR members' supervision, and to reducing the risks and costs to market users.

II) The network of EU Securities Regulators: challenges and improvements

Page 10:
We agree that the priority is to use the tools provided by the Lamfalussy approach and FSAP measures as far as possible, and to adopt a 'gradual approach'.

We think that CESR's suggestion that success at convergence should be reported to demonstrate accountability needs to be considered in the light of our comments on Key Point 4 of the Executive Summary on 'democratic accountability'. We welcome the proposal that the process of convergence should take place with some degree of visibility. However we suggest that the purpose of reporting should be to encourage transparent and consistent good conduct. We would be concerned by any implication that it was not appropriate for supervisors to co-ordinate their activities (where pragmatic and useful) amongst themselves in areas that are not specified in the legislation. We agree that regulators should, ultimately, be accountable (principally to the relevant Member State) for supervisory activity. It is not in our view necessary, however, for all the detail of supervisory activity to be prescribed in legislation in order to achieve accountability. We suggest that CESR should seek CEBS's views on this matter also.

In line with CESR's policy of using existing tools, CESR's suggestion that it could act as a "supervisor of national supervisors" should not go beyond identifying and pointing out differences in methods of application, and must not imply a legitimated authority structure, with specific powers and sanctions.

CESR describes the "Network" of supervisors as limited because its adoption of a common approach depends on the use of non-binding legal instruments. It is important not to over-emphasise the absence of a legal framework. At a stage where we do not necessarily know what the "right" or "good" or "best" approach is, we should be very wary of prescribing a particular approach in legal instruments in a way that would be difficult to change if that approach proved, over time, to be ill advised, or if better alternatives were identified. We consider that CESR should strive to ensure coordination and general good order by using ‘soft form’ arrangements based on consensus, permitting greater flexibility in the allocation of who does what and in what circumstances, rather than seek to mandate in ‘hard form’ the structure and allocation of all roles and responsibilities.

IIb) The challenges that CESR Members will face when the FSAP is implemented

Pages 12/13:
We strongly agree that there is a need for common understanding of regulatory objectives. This is consistent with the Lamfalussy Report’s recommendation for agreed overarching principles of regulation. We also agree the need to calibrate regulation appropriately, and stress that this needs to be done by reference to different market users’ different need for protection, taking account of the fact that participants in professional markets have a greater ability and resources to protect their own interests. We also think that it is important to develop an accurate analysis and presentation of the differences between regulatory approaches. For example, under the heading 'convergence of approach' the Report sets out 'different' approaches to market confidence, and suggests that adopting a 'market failure' approach is different from measures aimed at 'allowing markets to function properly'. We do not consider that this is the case. One of the key advantages of the 'market failure' approach to regulation is precisely that it focuses regulatory attention on markets that are inefficient (and therefore do not work properly), and avoids the costs of regulatory interference in efficient markets.

Diversity of regulators’ formal powers should not be a problem provided there is clarity about objectives, and regulators’ powers are equally effective. There is rarely only one right way to do anything and there are good reasons why regulators may need to exercise their powers in different ways. This flexibility should be preserved. However, it is of course vital to ensure that no supervisor is without effective powers to act. There needs to be an assessment of the minimum necessary level and scope of powers.

It is important to recognise that a common approach and the fairness of application of EU directives are conceptually different questions. It is also important as regards fairness of application to distinguish between a legitimate application of a Directive that imposes comparatively onerous requirements on firms in a particular Member State, and an illegitimate mis-application of a directive which is properly a matter for enforcement action at Level 4. CESR is right to recognise prevention of protectionist implementation of directives as a key issue.

‘Supervisory intensity’ is however too nebulous a concept to measure or assess the effectiveness of Member States’ implementation. Different ‘intensities’ may be appropriate and equally effective in different markets or supervisory environments.

Page 13:

Cooperation:, We think that the emphasis should be on encouraging cooperation by non-legally-mandated mechanisms. It is of course important to ensure that there are no legal barriers to cooperation. But it would be dangerous to assume that a legal mandate or other form of immediate intervention was necessary to achieve cooperation. Scope should be provided to allow cooperation to flourish without legal constraints, not least as supervisors should not seek to consider only the minimum legal duties of cooperation.

Measuring performance We support the principle of peer review and benchmarking. However, it will be important to ensure a proper approach if a CESR member is considered below desired standards. This is by no means necessarily a role for other Member States' supervisory bodies, either severally or collectively via a "supervisor of supervisors". The information that, in the view of the peer group, the national supervisor is substandard should be shared with the relevant national government bodies (presumably the ministry of finance). Any other role for bodies outside the Member State in question would open debates on the reasonable limit of self determination by the Member States in the EU. In the absence of compelling or demonstrable evidence that substandard performance by the supervisor creates a threat to other Member States and their financial entities or financial system, it is important not to create the expectation that other Member States have a right to intervene beyond drawing the matter to the attention of the relevant national bodies and informing the EU institutions and relevant Level 2 Committees.

Identification of emerging issues It is vital for the success and international competitiveness of EU financial markets to encourage innovation in products and services in the EU. CESR's role should be to focus on ensuring mutual recognition and removing barriers to cross-border provision. The Report acknowledges that an innovation will inevitably affect only a minority of EU members, and that this constrains CESR's locus to act. However, the paper appears to argue for a collective view on innovations on the ground that they will spread across the EU. A requirement to obtain such a collective view would operate as a strong disincentive to innovation in the EU, and could undermine MIFID by suggesting that host States should still have a role in regulating cross-border services. Innovation and creativity are vital in securities markets in all Member States. It is therefore essential that the responsibility for regulatory assessment of innovations remains with the Member State concerned, as provided for under MIFID.

IIc) The adaptive improvements of the Network of securities regulators

(i) Convergence in Supervision

(a) The coordinating supervisor should be determined bilaterally or multilaterally between the relevant regulators. It is necessary to take into account the Financial Groups dimension and the interface with

CEBS. This is not an area where all directives are silent. Very few supervisors of groups will be “only” banking supervisors or “only” investment firm supervisors. It is important to be clear about the kind of supervision under consideration, the complex interface between prudential and conduct of business regulation, and the wide range of firms affected – both credit institutions and investment firms.

(b) We support the secondment of staff between CESR Members.

(c) We support the proposal to set priorities and allocate resources at CESR level in case of market shocks.

(d) We strongly agree the need for transparency of any MOU arrangements.

(e) Joint investigations should be pursued bilaterally or multilaterally between the relevant regulators. CESRPOL/CESRFIN could serve as a coordinator of activities or resources in joint investigations. However, since CESR is not a competent authority for the purposes of enforcement, it could not, and should not, have a formal role in investigations.

(f) We support the proposal for transparent databases of sanctions.

(g) We encourage CESR to provide mediation facilities if there is lack of cooperation between regulators, to the extent its members find this role useful. However, the success of mediation will build with trust over time, and CESR should not seek to force mediation on its members.

(h) We support the proposal to enhance transparency of regulators' decision-making.

(i) See our comments on section IIb) above on 'pre-clearance' of innovative products at CESR level. Such a central process could help to smooth mutual recognition and remove barriers. However, it is critical that such a process does not impinge on approval of the product or service itself, which should continue to be determined by the regulator of the market where the innovation is introduced. Similarly, it is important that any arrangements on consulting other CESR members on decisions that have a 'significant impact' on other market players do not inhibit innovative products and services.

(ii) The fair implementation and application of directives

(a) Supervisory practices may vary depending on local context, and variations may be unmeasurable. Except in the extreme case where supervisory powers are clearly inadequate, and obstruct the regulators' ability to cooperate to ensure adequate transposition, it is more important to focus on whether supervisory practices focus appropriately on 'overarching objectives' and are equally effective, rather than on 'supervisory intensity'. We welcome the recognition that divergences of regulatory practice, when not well founded, can lead to unnecessary and high costs.

(b) We support the proposed role for the Market Participants Consultative Panel to identify barriers to a single market caused by inadequate application of directives.

(c) We support more intensive checking of transposition by the Review Panel.

(d) The proposal for a wider-scope CESR mediation mechanism to resolve conflicts of interpretation of Directives needs to take account of difficult issues relating to the interaction with the Commission's prerogative and national regulators' national accountability. We support CESR's making available a voluntary mediation mechanism, but it should not have a role in formal adjudication of disputes.

(e) We support the proposal for systematic peer reviews. Supervisors need to be more transparent so that they can learn from each other.

(f) We support the proposal for more publicity of inadequate application of Directives.

(iii) Definition of a Mission Statement for EU securities regulators

(a) We strongly support the proposed agreed statement of overarching objectives of regulation as recommended by the Lamfalussy Report. We agree that this would need to take account of the global dimension of EU financial markets.

(iv) The access by regulators or by the general public to regulatory information on an EU wide basis

(a) As CESR acknowledges, central databases of transactions and regulatory information from listed companies would be a major project, involving significant IT investment. It would be necessary to examine thoroughly whether the resulting benefits justified the cost outlay.

IId) Improvements that might be considered by EU Institutions

<u>Pages 16/17</u>.
We agree that all possible tools under the existing framework should be used before 'more far-reaching solutions' are sought. We strongly agree that there would need to be 'demonstrable evidence' that existing tools were not effective, including cost-benefit analysis, and that it would be necessary to demonstrate greater cost efficiency from action at EU than at national level.

We think that the 'imbalance in supervisory relationship' criterion should be qualified. It is appropriate to be concerned if all significant decisions about the regulatory arrangements of a branch in a Member State's territory are being taken elsewhere, and the impact on that Member State's financial system if the hosted entity collapsed would be catastrophic. However, it is also vital not to undermine the fabric of the single market and the effectiveness of the passport. We suggest that the first step in resolving these tensions lies in the cooperative mechanisms that are being discussed. We assume that the statement "there is real paralysis…" is a contingent one: there is no such paralysis at present. Furthermore, it would be necessary to take account of the fact that following the collapse of BCCI, the "Post-BCCI Directive" (95/26/EC) was introduced to provide a framework for dealing with such problems.

On page 17 CESR identifies a number of areas where stresses might arise. However, they have not arisen yet, nor have the available tools for managing such stresses been found wanting. Until this occurs, and consistent with the comments we make in 3(f) of our General Comments above, it is not appropriate for CESR to be contemplating that existing mechanisms will be found wanting.

III) Mutual Recognition: the challenges posed by multi-jurisdictional market players

IIIa) The Home/Host relationship: new challenges

<u>Page 18</u>:
We suggest that CESR should focus on the effectiveness of supervision, not the means by which it is done. It would be very difficult to measure 'equivalence of powers' and 'supervisory intensity', whereas agreed overarching objectives would provide a benchmark to measure effectiveness of supervision.

<u>Pp 19/20</u>:
The conclusion that trans-national groups are testing the limits of traditional home/host arrangements needs to be viewed in the light of specific arrangements for branch business in existing legislation and the country of origin approach. No action is needed to the extent that existing regulation provides appropriately for regulation of services provided cross-border from a branch.

The itemised bullet points demonstrate the overlap between prudential and banking supervision and investor protection. The bullet points cannot be considered in isolation from a discussion of how these matters would be dealt in the banking and prudential field.

IIIb) Possible improvements of the Supervision of multi-jurisdictional market players

<u>P20</u>:
As a core principle, we think that CEBS should be fully involved in any decisions on the possible improvements.

Regarding suggested cooperative arrangements, we have the following thoughts:

Cooperative arrangements that can be rapidly put in place

(a) Joint inspections: CESR could coordinate activities and resources, but the inspections themselves should be organised, planned and conducted bilaterally or multilaterally by the relevant regulators.

(b) Home/host consultation before decision-making: This should be arranged bilaterally or in a multilateral or collegiate fashion by the regulators concerned.

(c) Information on sanctions and preventive measures: We support the proposal.

(d) Direct access to remote market members: We support the proposal.

(e) Contacts and communications re continuity of operations: We support the proposal.

Cooperative arrangements to be considered

(a) Exchange of supervisory programmes: This is a good way for regulators to learn from each other, and CESR should encourage the practice. However, the specific arrangements for exchange of supervisory programmes should be managed by the regulators concerned.

(b) Delegation of supervisory tasks: We think that this is better dealt with by the relevant regulators themselves.

(c) Notification of emergencies: We support the proposal.

(d) Staff secondment: We support the proposal.

(e) Exchange of supervisory information: Depending on the nature of the information in question, this could be a matter either for CESR involvement or for bilateral contact between the relevant supervisors.

Possible future cooperative efforts.

In principle we think that CESR's proposals have merit. However it is important to recognise that the projects suggested – harmonisation of reporting arrangements, and development of common tools such as a 'data room' - would be major in scope and would have to be carried out over a long term horizon. Please also see our separate comments on the MIFID consultation in respect of harmonisation of reporting.

IIIc) Improvements that might be considered by Member States and EU institutions if convergence is not achieved:

See our comments above on equivalence of powers.

In general we support the concept that competent authorities can delegate certain powers to other authorities. This might be quite fruitful in some cases (and may be needed in the CEBS field). We note that CEBS's discussions (largely though not solely in the context of internal ratings based models) seem to favour as much local supervisory action as possible to avoid duplication and overlap.