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2006 report on Supervisory Convergence in the field of Securities Markets

Executive Summary and Key Priorities

As a general statement CESR has during the time since the last progress report made significant progress in order to enhance mutual understanding and to narrow down the differences of supervisory practices. The shift in nature of CESR's work from the provision of advice on level 2 to the Commission to the more operational level 3 work has increased during the last year. CESR has considered very carefully what changes will be necessary for CESR to make in order for it to meet the future challenges it now faces. Therefore CESR set up a task force and has agreed on a number of strategically important changes for the years to come. This will include a three criteria test to establish which work CESR will undertake, ensuring an operational focus on its work.

During the course of the last year there has also been significant increase in CESR's work with its fellow level 3 committees, (CESR, CEBS and CEIOPS) since the execution of the Joint Protocol and a joint level 3 work programme.

The ECOFIN has in its conclusions of the 5 May 2006 underlined that the continued success of the FSAP is dependant on intensifying supervisory convergence and has instructed the FSC to monitor the convergence of supervisory powers. Furthermore, the ECOFIN has underlined the implementation of supervisory tools such as mediation, delegation, streamlined reporting requirements and data-sharing arrangements as essential in order to make this convergence a reality. CESR is already well on its way to putting the ECOFIN conclusions into practice by introducing several new supervisory tools, namely a mediation mechanism which shall be up and running during the course of the summer, establishing a group to deal specifically with all IT-related issues among its members including data-sharing arrangements and establishing funding principles for such arrangements, establishing a group of financial markets economists to enable CESR to keep up with market developments and creating a method by which CESR can build in consideration of cross-sector aspects when developing its work. In addition to this, CESR will continue to strengthen a common culture by establishing tools to deal with issues such as staff exchanges. On an ongoing basis CESR is continuing to strengthen the common operational abilities of its members in areas of market integrity and financial information.

Remaining obstacles to supervisory convergence in the area of securities still exist. CESR consider that there is a need to address the following:

- a) There continues to be a lack of clarity among Member States regarding who the relevant competent authorities under the Transparency Directive are, which, given its imminent transposition on the 20 February 2007, may result in a delay of its timely implementation in some Member States thus diminishing supervisory convergence.
- b) The delay in making a decision about applying rules regarding the equivalence of third countries GAAP and in particular US GAAP, is a significant risk to achieving harmonisation of treatment by CESR members of third county GAAP's and thereby issuers who use them.



c) CESR finds the lack of harmonisation of sanctioning powers in relation to breaches of market integrity rules to be an obstacle to achieving supervisory convergence.

I CESR's Supervisory convergence policy for the next years.

I. 1. Background

1. In 2005 CESR delivered its first report on supervisory convergence for securities markets (CESR/05-202) to the FSC following an invitation from the July 2004 FSC-meeting. This, the second progress report includes in specific boxes, current limits to supervisory convergence to which the attention of FSC members is drawn.
2. CESR welcomes the ECOFIN conclusions of the 5 May 2006 on Financial Supervision and fully supports the final version of the FSC report on financial supervision and its key recommendations.¹ In its conclusions, ECOFIN invites CESR to take the following measures as a pragmatic response to the main challenges the EU faces in financial supervision:
 - assessing the functioning of the tools aimed at fostering a supervisory culture;
 - establishing a mediation mechanism between its members;
 - putting in place systems to facilitate the delegation of tasks and powers between its members;
 - streamlining reporting requirements; and
 - establishing IT data-sharing arrangements.
3. This report presents the way in which supervisory convergence is now CESR's key priority and the concrete results that have already been achieved.

I. 2. The shift in CESR's focus during the next years

4. During the course of the last year CESR has taken a number of practical steps in order to reflect the changes in the nature of its work and the challenges of supervisory convergence. These steps took the form of a task force mandated to define CESR's medium term priorities and recommend any changes that may be required in the way that CESR works. The work of this task force has resulted in a number of recommendations, which have already been ratified by CESR during its May 2006 meeting, some of which have been implemented and some of which will be implemented during the course of this year. To reflect the shift in CESR's focus during the next years CESR has identified a number of key priorities and supervisory tools needed to put them into practice, as set out in more detail below.

A) CESR'S Key priorities for the near future

5. Now that the burden of providing technical advice to the Commission has diminished, CESR will give priority to operational issues intended to promote de facto supervisory convergence. To do so, CESR will maximise the use of its membership by drawing on networks of specialists from its members whose composition and working methods will be flexible.

In order to be able to prioritise the areas of work that CESR will now undertake as master of its own agenda, rigorous criteria have been established and only work that meet these criteria will be undertaken from now on. All work will need to pass the following three part test:

A) **Risk** –the issue identified as a possible priority for supervisory convergence has to represent:

¹ FSC 4159/06.



- (a) a significant market failure; or
- (b) a repeated or major regulatory/supervisory failure.

B) EU Dimension – the issue identified is likely to have an EU-wide impact on market participants or end users (whether retail or wholesale), and on the smooth functioning of the single market.

C) Role of CESR - the issue identified as a possible priority for supervisory convergence is something about which CESR can positively do something, for example by providing input and influencing, thus creating change, or by the collective direct action of CESR members.

6. Subject to an assessment against the above prioritisation criteria, future areas of work that CESR may undertake will include the following:
 - the Monitoring of the home/host relationship and, in particular, practical improvements to home/host collaboration;
 - the development of IT data sharing arrangements or databases;
 - practical MiFID level 3 work to facilitate the daily application of the directive;
 - ensuring consistency of application of IFRS and the proper functioning of Prospectus Directive and Regulation;
 - participating in the asset management modernisation debate (including its cross-sector dimension).
 - an evaluation of the need for common approaches to takeover bids and corporate governance issues.
7. In addition and with the prioritisation criteria in mind, CESR will give due consideration to **cross-sector aspects** of the issue (and hence the need to interact with CEBS and CEIOPS), the **size of markets** particularly in new Member States and, where applicable, options provided by **self-regulation**. **Regulatory simplification** will also be an objective (for example the deletion of standards where appropriate).
8. Recognising the importance and benefit of ensuring a continued input from market participants in achieving supervisory convergence, CESR will also improve its ability to benefit directly from market participants' input during the development of its strategic thinking as well as in contributing to quality responses from consumers and end users. In order to reflect its need to be proactive as opposed to reactive, CESR will improve its ability to analyse and to anticipate the regulatory issues that members may be facing in the future, and CESR will develop ways of performing thorough economic analysis and empirical research.
9. In light of the importance that is placed on applying evidence-based analysis to proposed regulatory changes, CESR will also conduct an analysis of what the current methods of impact/cost benefit and evidence-based analysis are in order to evaluate the use of a similar form of methodology at CESR level taking into consideration the impact of such methodology on the timeframe of its work.

B) Supervisory convergence tools to achieve CESR's shift in focus

10. In order to achieve greater focus on operational issues, CESR will put in place the following tools in order to promote supervisory convergence:
 - CESR will encourage the operational work of its groups relating to its work on financial information and market integrity, and develop its implementation networks within which convergent views on the provisions of Directives will be discussed at the time when Member States are transposing the Directive and actively support the Commission's work in this area.



- To make the most effective use of IT data sharing arrangements, CESR will also develop databases containing details of members' actions in respect of issues of common concern (in particular, the implementation of directives).
 - CESR will take active steps to develop a common culture – for example through the exchange of staff and the creation of opportunities for common training events and through the development of common supervisory approaches to regulatory issues that fall outside the detailed scope of the directives that have an impact on supervisory convergence.
 - As part of the need to improve peer pressure and supervisory convergence, CESR will give new impetus to its group that deals with the cross-examination of convergent application of the FSAP. Recognising the importance of the use of peer pressure as a tool achieving supervisory convergence CESR will also establish ways of making maximum use of 'peer pressure' at Chairs level.
11. Through the identification of key priorities and the establishment of tools to achieve them, CESR now has a sound basis upon which it can focus on supervisory convergence. CESR has already started to make changes of both a formal nature (by making changes to its Charter,) and of an operational nature by changing how its members work in order to give more force to the level 3 work and benefit from more efficient decision making processes.

II Concrete results of Supervisory Convergence in operational areas

12. This section sets out the practical work done in some of the operational groups of CESR since its first progress report. For a more detailed account of the work done in each group, please see the Annual report for 2005.

II.1 Market integrity

13. The CESR group that deals with market integrity is an operational group called CESR-Pol which undertakes work on cases related to market abuse and the Market Abuse Directive. In reflecting the shift to operational day-to-day work, CESR-Pol has, during the course of the last year changed the way it is structured in order to strengthen its ability to undertake operational practical work. CESR-Pol has two different types of sub-groups to help it in its work: the Urgent Issues Groups (UIGs) and the Surveillance and Intelligence group.
14. UIGs are small ad hoc groups addressing specific issues that call for cross-border investigations. The work involves carrying out common investigations with those CESR-members who are affected by a certain issue. CESR's experiences of the UIGs to date (which have been established on four separate occasions) have been positive and this type of group has been found to be valuable. The UIG's have been working very well within the current legal framework. However, CESR points out, that when it comes to taking action, the differences in applicable laws and processes of members expose their collective weakness in their ability to take joint action in market abuse cases.
15. As another example of supervisory convergence in action, CESR created in late 2005 a Surveillance and Intelligence group. The group's objective is to create best practices and it performs work related to different types of market abuse cases such as: insider dealing rings and manipulation in low liquidity shares, investigation techniques and working methods, safe harbour information requirements and regulations and cross border cases.
16. Building on experiences from a common investigation in 2004-2005 involving several CESR members, CESR found and put down on paper in a letter to the FSC and the Commission in July 2005, that the practical results from the investigation were severely diminished as a



result of very differing degrees of sanctions in member states related to market abuse, and also the differences in the nature of sanctions and in how market abuse cases are treated. As CESR pointed out at the time, any credible home/host relationship or network arrangement cannot work if the relevant authorities do not have equivalent and rigorous powers to supervise, investigate, sanction and exchange information regarding financial market activities. CESR also volunteered to monitor the supervisory powers existing among CESR members, together with the FSC and the Commission. As mentioned elsewhere regarding the Review Panel, CESR has also begun the mapping of supervisory powers in the member states and will provide input to FSC for its monitoring of supervisory convergence.

Database for market abuse enforcement cases:

17. In the near future, CESR will set up a database through which enforcement decisions made/sanctions imposed in respect of breaches of the national legislation implementing the Market Abuse Directive can be stored and accessed by all CESR members. CESR is convinced that easily accessible pan-European data bases will significantly facilitate the convergent application of the Market Abuse Directive.

Limits to convergence:

CESR has, following experiences from conducting common investigations - observed a great variation between member states in the level of sanctions that can be imposed in market abuse cases. CESR finds the lack of harmonisation of sanctioning powers between members to be an obstacle to achieving supervisory convergence. CESR did in the aforementioned letter of 2005, also volunteer to conduct a mapping exercise among CESR members regarding the different sanctions available in member states.

II.2 Financial information

18. The CESR group that deals with financial information is CESR-Fin. It is responsible for coordinating the efforts of CESR members' endorsement and enforcement of financial reporting standards in Europe. In order to make the group more operational CESR has recently decided to restructure CESR-Fin.
19. In the light of the fact that accounts in EU listed companies from 2005 have to follow IFRS, CESR-Fin through its operational sub-group EECS (European Enforcers Committee on Supervision) is committed to:
 - analysis and discuss decisions taken or to be taken by EU National Enforcers on the enforcement of financial requirements to achieve harmonisations and coordination of future decisions;
 - identifying issues which are not covered by financial reporting standards or which may be affected by conflicting interpretations for referral to standard setting or interpretative bodies such as IASB (International Accounting Standards Board) or IFRIC (International Financial Reportings Interpretations Committee);
 - sharing and comparing practical experiences in the field of enforcement on issues such as selection, risk assessment and enforcement methodology;
 - helping to identify and providing advice on enforcement issues that may require future CESR standards and guidelines.
20. The overall objective of these operational activities is to contribute to a consistent and proper application in the EU of IFRS.
21. CESR-Fin also has an ongoing dialogue with the US Securities and Exchange Commission (SEC) regarding the possible application of IFRS in the US and the equivalence of US GAAP in Europe. The area of IFRS and USGAAP form a very important part of the SEC-CESR work



plan for next year, where the methods of dialogue has recently been upgraded and intensified.

The CESR-Fin database

22. For the purpose of attaining convergence on future decisions and to improve technical knowledge on accountancy and enforcement practices, CESR has developed a database for storing and accessing enforcement decisions taken by national competent authorities. In order to reflect the fact that in some jurisdictions it is not the CESR member enforcing IFRS, access has been extended to national enforcers who are not CESR members.²
23. The use of the database commenced in August 2005 and currently holds 46 cases. The type of issues that have to date been sent to the database have concerned by example transitional issues/first time application, the scope of the standards and the uncertain situations resulting from insufficient guidance. The CESR–Fin database is proving to be a useful tool among CESR members. CESR points out that the creation of the database is in line with the ECOFIN conclusions.
24. Following the implementation of the IFRS in Europe in 2005 CESR will in 2006 conduct an evaluation of the evaluation of IFRS in the EU. A report will be presented in early 2007.

Limits to convergence

It can be expected that, to some extent, work of the EECS and the creation of the database alone can address the limits to convergence that CESR highlighted in last years report, namely that a large number of different competent authorities within member states have been tasked with implementing IFRS.

The fact that the European Commission may decide to postpone the application of equivalence requirements for third country issuers from 2007 to 2009 may continue incongruence of financial reportings on EU markets depending on the country of origin of the issuer, and many different sets of not fully equivalent reporting standards will continue to be reported, limiting comparability and understandability of accounts between CESR members in relation to the treatment of third country issuers, especially in relation to US, Canadian and Japanese GAAP.

In relation to the Transparency Directive one major obstacle to supervisory convergence is the fact that many member states have not yet appointed competent authorities.

II.3 Prospectuses contact group

25. The scope for interaction between regulators has increased following the transposition of the Prospectus Directive on 1st of July 2005. It is essential to have converging applications between competent authorities, especially in the first phase of applying the new rules.
26. Following on from the transposition the new directive, despite the fact that it is a full harmonisation directive, CESR has found it necessary to establish a prospectus contact group in order to facilitate the convergent functioning of supervisors' operational work and the smooth functioning of the markets and the prospectus passport. The agreements reached by CESR are to be published on the CESR website, as a method of informing market participants of agreed common approaches. It is anticipated that the work of the group will be valuable for supervisory convergence, as was the case with CESR's recommendation (CESR/05-054b) on the consistent implementation of the Prospectus regulation.

² The creation of a data base may have addressed the problem of differing authorities in the EU in the area of financial reporting, since CESR has given access to the data base also to non CESR members, as was expected by the FSC report on financial supervision (in paragraph 7 of annex 3.)

Limits to convergence:

It is still too early to tell whether voluntary level 3 measures and/or cooperation constitute a remaining weakness when aiming to achieve supervisory convergence practices. However, tools designed to increase peer pressure among CESR members for example the Review Panel and the publication of common approaches should in these cases serve to help.

III Practical tools to enhance supervisory convergence

III. 1 Cross-examination of convergent application of the FSAP directives (Review Panel)

27. The CESR group that deals with cross-examination of convergent application of the FSAP directives is called the Review Panel and it is also a tool through which CESR assesses the degree to which its member's have implemented CESR standards, guidelines and recommendations, i.e. supervisory convergence. As explained above in paragraph 13 CESR will provide new impetus to this group in its cross-examinatory role in the area of thematic peer reviews and as a provider of recommendations to CESR.
28. CESR has established an IT tool for members to fill out self-assessments which are assessed by peers. Together with these tools CESR has developed a full methodology that needs to be followed when determining the level of implementation.
29. Transparency of the assessments is a crucial part of peer pressure. During 2005-2006 the review panel conducted work in relation to three different areas: Standard No. 1 on financial reporting, the standard on cold calling in the area of investor protection and the CESR guidelines on the transitional provisions amending the UCITS directive.
30. Standard No. 1 on financial information contains a definition of how, in CESR's view, harmonisation on the institutional oversight systems in Europe may be achieved. It also contains enforcement standards on financial information, its scope, the selection techniques used and the responsibility of involved parties.
31. CESR has also reviewed the extent, to which its members have implemented the CESR standards on investor protection in relation to cold calling. This review includes a preliminary assessment of the impact of the MiFID rules on the cold calling standard and an assessment of the impact of the Distance Marketing Directive on cold calling standards.
32. Thirdly, CESR has reviewed how members have implemented the UCITS Guidelines. These guidelines were developed in order to converge different administrative practices that Member States had developed due to ambiguities contained in the UCITS III legislative texts. The review on the UCITS Guidelines has been done in three parts, a transitional guideline for a simplified prospectus, treatment of UCITS I funds authorised between 13 February 2002 and 13 February 2004, and the third phase concerned grandfathered UCITS I management companies managing passportable UCITS III funds. The separate reports are also published on CESR's web site³.
33. The Review Panel has also commenced a comprehensive mapping of supervisory powers amongst its members, both in relation to the Prospectus Directive and the Market Abuse

³ Final report by the review panel on the Common Implementation Review of the CESR's Cold Calling Standards (CESR 05-418b) The report deals with the implementation of the Investor Protection Standards related to Standards 18 to 24 on cold calling (Ref. CESR/01-014d). The second report is the summary of self-assessments of the implementation on standard No. 1 on Financial Information (CESR 06-185) and relates to the CESR standard agreed among members in April 2004 setting out standards on how institutional oversight in Europe may be achieved. Thirdly the review panel has published its report on the recommendation on transitional guidelines for UCITS. (CESR 06-103.)



Directive. As highlighted by ECOFIN in its conclusions, supervisory convergence needs to be intensified in order to fully benefit from the FSAP and related measures and thus to reap the benefits of the integrated financial market. ECOFIN has asked FSC to monitor the convergence of supervisory powers at an adequate level. The mapping exercise that CESR is conducting will provide valuable input into the FSC's work and the fulfilment of its task.

III.2 Development of IT Data sharing arrangements (CESR-Tech)

34. The increasing number of legal obligations requiring capital investments to develop some form of IT solutions, resulted in CESR establishing a group (CESR-Tech) to deal specifically with IT related issues, stemming predominantly from the FSAP-directives. In the absence of any EU funding in relation to the necessary IT requirements stemming from these directives, CESR has with difficulty been developing its own funding principles for financing developments of various IT projects.

Limits to convergence:

For CESR members to meet the implementation deadline of the exchange of transaction reporting requirements of November 2007, political support and appropriate human and financial resources are needed.

Although CESR has established a method through which CESR members can finance their IT related legal obligations stemming from the FSAP measures, it will at some point be necessary for the funding of such projects to be politically addressed as the system obliges national competent authorities to cover both the heavy costs of their national IT systems and to contribute to the financing of IT data sharing systems at EU level.

III. 3 Development of a common supervisory culture

35. In order to create a common culture among CESR members it is an indispensable precondition to create tools for achieving supervisory convergence at an operational level. Such measures are also fully in line with the FSC recommendations. CESR members envisage doing this through the exchange of staff and the creation of common training programmes. CESR has already held its first meeting among human resources managers within the membership and has conducted a questionnaire regarding the possibilities, willingness and experiences relating to exchange of staff and common training programmes. The result of this work to date shows that the exchange of staff for training purposes and for shorter periods of time is to a certain extent taking place. It is, however proving more difficult to arrange the longer lasting secondments, at more senior levels.

Limits to convergence:

CESR's first fact finding in this area shows that some limits to convergence in this area exist. Subject to further work, it can be flagged at this early juncture that: there is a language barrier, which in many cases calls for tailoring positions; there is also an issue of cost in funding and managing secondments; finally an issue may be differing tax regimes and differing legal status in between authorities. (In some member states there is a requirement to become a civil servant in order to become an employee.) CESR will report in more detail on this issue in 2007 after gathering further evidence.

III. 4. Mediation

36. During the course of the last year and in line with the ECOFIN conclusions CESR has been finalising a mediation mechanism and anticipates having such a mechanism in place before the summer of this year following changes to its charter. CESR is therefore confident that it will be able to meet the deadline set by the ECOFIN in its conclusions, to have a mediation mechanism in place before the end of 2006.

IV Supervisory convergence beyond CESR

SEC

37. Formal cooperation between SEC and CESR has been in place since 2004. The SEC and CESR are currently in the process of finalising a work plan for the years to come. The most important item on that work program will be the work on IFRS and US GAAP as discussed in paragraph 21 above.

CFTC

38. CESR and CFTC entered into a common work programme in June 2005 for the facilitation of trans-Atlantic derivatives business and have recently started publishing country specific information about derivatives regulation.

Limits to convergence:

The postponement of the decision of the advice on equivalence which CESR has delivered to the European Commission last year constitutes a limit to convergence, and could possibly delay progress on convergence of US GAAP with IFRS.

3L3 - CESR, CEBS and CEIOPS

39. The work between CESR, CEBS and CEIOPS - 3L3 – has during the course of the last year been cemented and intensified following the signing of the Joint Protocol on cooperation between the three committees and the adoption of joint annual work programme starting in 2006.

Joint Level 3 work across financial sectors

40. Key to supervisory convergence is the increasing cooperation and cross-sectoral work of the Level 3 Committees. The Level 3 cooperation ranges from information exchange on work under way in the individual sectors, to work undertaken together. According to the Joint Protocol signed in November 2005, the main responsibility for facilitating and ensuring good cooperation lies with the Chairs, assisted in this effort by the Secretariats.

41. The participation and results for cross-sector work of the three Committees may be summarised under the following subject headings:

Financial Conglomerates

42. CEBS together with CEIOPS have set up an 'Interim Working Committee on Financial Conglomerates' (IWCFC), of which CESR is an observer. The first aim of the IWCFC will be to assess the current status of the Financial Conglomerates Directive's transposition and assist in the consistent application of the Directive for the conglomerates identified. The IWCFC is prioritising the convergence of national supervisory practices on issues concerning, for example, capital requirements, intra-group transactions and risk concentration. Identifying and establishing cooperation and coordination requirements between the supervisors involved will be another important task.

Joint work

43. Besides the work on financial conglomerates, work aimed at providing common definitions of Level 3 measures (standards, guidelines and recommendations) is planned.

Consistency Projects

44. Under this heading, mapping and comparison of sectoral work projects are envisaged. They will aim to streamline processes and develop consistent approaches across sectors. This might lead to future joint initiatives. Work on the following aspects is currently planned.

a. Outsourcing

45. The objective of this work is to create consistency between CEBS' outsourcing standards and Level 1 and 2 requirements included in the MiFID. To avoid inconsistencies in these developments, CEIOPS is participating in the alignment in view of its work in the framework of the Solvency II project.

b. Supervisory cooperation

46. The Committees will compare their work on regulatory approaches and cooperative arrangements with regard to the relationship between home and host competent authorities in a group environment. The objective of this work is to research whether the individual sectoral work done by the Committees might be extended to cooperation with supervisors or competent authorities in the other sectors, and to take on board their respective good practices. This should ensure greater cross-sector consistency of approaches. The comparison will be done during the course of 2006.

c. Reporting requirements

47. The Committees will take stock of potential inconsistencies and overlaps between sectors in reporting requirements, which originate in sectoral EU directives applying to European supervised entities and market participants. The Committees aim at presenting a first result of this inventory within the second half of 2006. Based on the inventory, future work may be proposed.

d. Internal governance

48. The work within the context of the CRD and the MIFID on internal governance of banks and investment firms will be further discussed. An analytical report will be prepared and shared with the market on any overlaps and areas of possible future work. For CEIOPS' purposes, this will take into account the current thinking on Solvency II.

Information exchange

49. The Committees ensure frequent exchange of information on all the topics of interest to each other in regular meetings of the Chairs and of the Secretariats, as well as through intensive contacts and discussions by phone and mail between the Secretariats and between the Members who have taken responsibility for drafting sector specific proposals. All meeting documents are distributed across sectors, as well as early drafts of discussion notes if relevant.



50. CESR has already started to adapt its work in order to take account of the increased need for cross-sector cooperation and as an example of this CESR, through CESR-Pol circulates it warning notices on unauthorised financial activities to CEBS.