



Date: November 2007
Ref: 07-783

A proposed evolution of EU securities supervision beyond 2007

I Context: Building on a success

By the end of 2007, the EU will carry out a full review of the Lamfalussy approach for the regulation of European Securities Markets. Within this context, CESR has contributed with several reports showing significant achievements outlining that in six years the EU has very successfully delivered the legal framework necessary to create a genuine single market for financial services.¹

Since the publication of the “Himalaya” report, CESR concentrated its efforts on ensuring a more coordinated and convergent supervision of securities activities in Europe (Level 3) and has welcomed the Thierry Francq report as endorsed by the ECOFIN conclusions of May 2006. This note, is based on the preparatory analysis by a specific Task Force² within CESR, it builds on these efforts to foster supervisory convergence in the Union and proposes ways and means to improve the role of CESR in this respect and suggest to the EU institutions possible evolutionary steps requiring initiative at political level.

This contribution should be read in conjunction with a joint paper of the 3 Level 3 Committees defining cross-sector key working priorities for the next 2-3 years and underlining supervisory issues that CESR has in common with CEBS and CEIOPS.

In line with the key conclusions of the IIMG³, CESR considers that the process of shaping EU legislation at Level 1 and 2 can still be improved in terms of process but should be regarded as a success that should be continued based on a stable inter-institutional agreement.

After some years of experience developing Level 3 tools to foster supervisory convergence in Europe, CESR would like to highlight the significant progress achieved in making securities regulators work more closely in the daily implementation of FSAP directives and also underline what can limit its ability to respond to expectations expressed by the EU Institutions and Market Participants.

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- ¹ - The European Single Market for securities – A factbook on Markets and supervision (07-306) – November 2007
- CESR’s review of the implementation and enforcement of IFRS – (Ref. CESR/07-352) - November 2007
- Market Abuse Directive – Level 3 – second set of guidances and information on the common operation of the Directive to the market (06-562b) – July 2007
- CESR’s report on the Supervisory functioning of the Prospectus and Regulation (Ref. CESR/07-225) – June 2007
- An evaluation of equivalence of supervisory powers in the EU under the MAD and the Prospectus directive. A report to the FSC (Ref. CESR/07-334b) – June 2007.
- ² The Task Force was chaired by Michel Prada (AMF), composed of Eddy Wymeersch (Chair of CESR), Carlos Tavares (Vice-Chair of CESR), Jochen Sanio (BaFin), Callum McCarthy (UK FSA), Lamberto Cardia (Consob), Istvan Farkas (PSZAF), Arthur Docters van Leeuwen (AFM), Vilija Nausėdaitė (Lithuania Securities Commission), Ingrid Bonde (Finansinspektionen), the rapporteur was Fabrice Demarigny, Secretary General of CESR.
- ³ See final report of the IIMG.



Activities at Level 3 can be categorised into three groups of issues:

- a) Common supervisory tools that facilitate cooperation between supervisors and favours the development of common supervisory culture. This category covers, in particular, operational cooperation, training of supervisors, exchange of staff, creation of databases and IT data sharing arrangements. These activities have been considerably developed within CESR for the benefit of all CESR members. The main difficulty and challenge for the future is the financing of those specific activities.
- b) Definition of common supervisory approaches through elaboration of standards, recommendations, guidelines or sets of practical answers to daily application issues. Most of the time, these activities have been developed within the scope of the FSAP directives with a decision making process that limits partially the risk of a veto right given to one member. These Level 3 measures have been developed closely with the industry, and following a rigorous “better regulation” method. In particular, CESR has developed impact assessment analysis, criteria to decide if measures are necessary and is conducting a deregulation exercise. It should, nevertheless be stressed that Common Level 3 approaches, once adopted, are implemented on a voluntary basis with members exercising a “peer pressure” on each other to apply them. Strictly speaking they are not legally binding and there is no legal enforcement process for non-application, but there is a strong expectation that they will be applied effectively.
- c) Conflict handling and peer pressure tools. So as to favour supervisory convergence, CESR has developed tools to identify the areas where differences exist and can be an obstacle for the Single Market (Review Panel) and to solve conflicts between supervisors (Mediation). The Review Panel has conducted extensive mapping and reviews that show that further progress can be achieved. The mediation procedure has not been in operation thus far. A limit to the full efficiency of these approaches comes from the fact that as soft law tools they cannot always be invoked in front of the national accountability system (political or judicial) governing each member of CESR.

It derives from the above that in parallel to the Level 2 activities over the last five years, CESR has developed progressively a number of Level 3 tools to ensure more cooperation between supervisors at operational level, to favour convergence in the supervisory practices and to enhance discipline between the members so as to avoid divergences in the daily application that could damage the fluid functioning of the Single Market. It should, be stressed that in this context, there is a gap between an informal (de facto) EU mandate given to CESR creating the expectation that rules will be applied in the same manner in the market, and the legal national accountability obligations of each CESR member that governs their daily activities. Uniform supervisory behaviour should not be expected by market participants within the current framework as CESR members may have no alternative but to respect legitimate national discretions.

The achievements outlined above testify to the strong commitment of the CESR members to supervisory convergence and to the methods that have been developed over the past 6 years. They have been realised thanks to the largely voluntary efforts of its Members with the support of the EU institutions, and this notwithstanding the absence of a clear legal standing of the Committee under European law, without a clarification as to its mandate, or without clear arrangements for sufficient financing.

Now, 6 years after its creation, CESR has reached a new stage in its development. In order to be able to pursue its objectives and ambitions, the adequacy of its legal regime, tools, powers, and financing have to be evaluated and, where necessary, brought up to date. To that purpose, the Committee has agreed to put forward to following propositions.

In this respect, it is the view of CESR that all possibilities at Level 3 have not yet been exhausted and therefore, taking into account the adaptation outlined hereafter, further progress can be achieved on the path of supervisory convergence. In addition, should the EU



institutions decide to initiate a legal recognition of the work achieved by CESR, several options could be considered.

II Additional supervisory convergence

It is CESR's belief that "supervisory arbitrage" within an integrated market is detrimental for the fair and safe functioning of the market and investor protection and that "referees" should not compete and should deliver a level playing field and convergent supervision. Accordingly, CESR strongly supports the need for further supervisory convergence and is convinced that significant additional progress under the current structures is possible and will require clearer commitment from its members to act in a convergent manner at EU level. In other words, a strong "team spirit".

A. A prerequisite: effective equivalence of supervisory powers

As stated on several occasions by CESR, the fact that the members enjoy effectively equivalent powers, enforcement and investigation tools, to act and cooperate with each other is a prerequisite to any supervisory arrangement in the Union. The evaluation exercise carried out by CESR on the MAD and the Prospectus Directive indicated that additional progress is necessary to achieve this outcome. The detailed analysis for the Transparency Directive and the MiFID has not been done yet. CESR would like therefore to insist on the need for effective monitoring, in the short term, of the need for equivalent powers granted to competent authorities by the Council, the Commission and the Parliament. The independent use of these powers is an essential part of this objective.

B. EU convergence and the national supervisors' legal mandate

The pursuit of supervisory convergence may in some instances not be compatible with the national supervisors' legal mandate and hence with their mission statement. Inability to cooperate and risks of liability may result. To remove any ambiguity as to the member's legal position, it could be considered to extend the national supervisors' obligation to cooperate within the European Union, as is laid down in the applicable directives, by an express reference to the cooperation with a view of attaining supervisory convergence at the EU level.

Extending in this way the national supervisor's mandate would provide the legal basis for their action at the EU level, and legitimise their decisions within CESR, without fear to act in conflict with their national mandate. It would also strengthen their legitimacy vis-à-vis their national constituencies, (e.g. on common projects and their financing). At the same time any doubt about the compatibility of their action with their national mandate would be removed.

Additionally, the next years might be the appropriate time to examine whether further convergence might be achieved in harmonising the use of – and possibly abolishing some – options and national discretions granted by the directives in the securities field.

C. Recognition of the role of CESR

Although created by Commission decision, CESR is not legally recognized in the directives or regulations relating to the subject matters that are administered by its members. An explicit reference in the EU legislation – as has now been proposed for other Level 3 committees – would greatly contribute to establish the legal standing of CESR in the European supervisory framework, while stressing the responsibility of CESR for the fields in which it develops its action, be it as an advisor to the Commission, or for the coordination of the action of the national supervisors with a view of supervisory convergence. Moreover legitimizing CESR's role in the implementation of the provisions of the directives would establish its double - (i.e. European and national) legitimacy and accountability.

D. Better Accountability



Along with the proposals developed in the previous paragraph, the explicit recognition of CESR as instrument for achieving supervisory convergence would clarify the accountability of its members' position, that now exclusively owe allegiance to the objectives stated by their national legislation, and without regard to decisions or initiatives that are essentially European in nature.

On a *de facto* basis CESR has up to now acted as if it was accountable to the Commission, the European Parliament and the Council. An explicit reference to CESR in the applicable directives or regulations, implying accountability to the mentioned European Institutions would enhance clarity in this field and allow CESR to justify its actions before the European institutions, while maintaining its members' accountability towards their national bodies, according to their mandate as adapted pursuant to the previous paragraph.

E. More authority given to Level 3 measures

According to the Charter of the Committee, the Level 3 common approaches agreed by CESR must be introduced by the members on a voluntary basis in their regulatory and supervisory practices. The checking of the way in which this is achieved is done through the Review Panel using a "comply or explain" approach.

One possibility to enhance the pressure on the members to fully implement the agreed level 3 measures is to include in the Charter, as a complement to the monitoring done by the Review Panel, a gradual set of enforcement instruments in case of non-compliance based on the association character of CESR. These "sanctions" would be fundamentally reputational, comparable to those applicable in a "club" as for example: public naming of non-compliant members. This will, of course, require due process rules to be respected including on-site thematic visits by a delegation of peers, as agreed previously by CESR.

Additionally, Level 3 measures would gain significant authority if the European Commission would more systematically welcome those measures by indicating that it will not ignore their existence when using its enforcement powers at Level 4.

Finally, within the current framework, CESR believes that it is preferable, at the present juncture, to keep the consensus rule for the approval of Level 3 measures (unanimity minus one or two) as long as these are not legally binding in order not to create over expectations. For cases of non-implementation of the kind mentioned above, members will have to discuss the possible use of qualified majority voting (QMV).

Strengthening the authority of Level 3 measures

In general, members voluntarily adhere and implement the common measures that have been adapted by consensus in the Committee. The degree of implementation is then determined in a Peer Review, undertaken by the Review Panel, composed of CESR members.

However it may occur that national practice diverges from the commonly agreed positions, be it a standard, a recommendation, or any other Level 3 instrument. In this case, on the basis of the findings by the Review Panel, the divergence or the deficiency will be exposed on a "explain" basis. A CESR member may not have implemented a specific standard or recommendation for several reasons, which will first have to be made explicit by that member, and after verification by the Review Panel, exposed to the Committee, if necessary after a thematic visit by a delegation of peers, as determined by the Committee. This procedure will require the principles of due process to be respected. The Committee may decide to publish its opinion, after having given that member the possibility to align its practice.

F. On Qualified Majority Voting at Level 3

According to its Charter, CESR decisions at level 3 are adopted by consensus, this being understood as unanimity minus one or two. However, the need to ensure the efficient



working of supervisory convergence tools advises the adoption of QMV for decisions related with their implementation. CESR will consider this in the near future.

This could be the case when results coming for peer pressure tools are at stake in order to avoid that inconsistencies in the implementation of supervisory measures are vetoed. For example the Review Panel work programme and reports could be approved and published by QMV.

Similarly, an additional step is conceivable for triggering entry into Mediation.

The consensus rule could also be waived in cases in which a certain matter reveals a tension between a member's position and the decision of the Committee. In these cases, there should be a rule that said member could not take part in the decisions.

QMV has to be calculated in accordance with the Treaty provisions prevailing at the time of the decisions.

G. More efficient peer pressure tools

CESR considers that supervisory convergence is best achieved by developing stronger level 3 instruments, voluntarily implemented by the Members on the basis of mutual trust. However in some cases implementation has to be compared, verified and if needed ensured by peer pressure. In order to ensure the implementation of community rules or avoid divergent supervisory practices, the Review Panel has already undertaken several comparative investigations and is increasingly exercising pressure on the members in case implementation of commonly agreed supervisory measures appears unsatisfactory.

In order to further roll back unsatisfactory implementation, or limit divergent supervisory practices, it might become necessary to step up pressure by intensifying the use of peer pressure measures, such as multiplying the fact finding exercises, analysing the reasons why a certain regulation or practice is to be considered incompatible with the member's obligation under EU law or under the Charter, noting the members' explanation and if needed, publish the finding.

For peer reviews CESR intends to favour more direct input from market participants in order to better identify the areas that would require a review or those blocking the smooth functioning of the Single Market.

H. More efficient cooperative tools

The ability for the Home and the Host(s) competent authorities to cooperate requires further clarification at EU level. If delegation of tasks between authorities seem possible in the area of securities (even if in some cases national law obstacles might exist), the delegation of decisions has an extremely limited scope and can only be put in place by a legally binding instrument. CESR will continue to actively work to pursue multilateral frameworks for delegation of tasks between authorities to be organised and gain step by step experience on voluntary delegation.

F. External direction of convergence

Market consolidation both inside and outside EU borders means that CESR is increasingly the advocate of common interests of the EU securities supervisors abroad. In line with the policy objectives of the Union and in specific areas decided by the Members, CESR could be the entry point for direct discussion leading to framework agreements (ultimately resulting in a bilateral basis). This could help the Commission in its political efforts to advocate the interest of Europe in the external dialogues and promote an EU model of regulation.

In addition, relying only on bilateral negotiations risk opening the door to possible competition between CESR members giving different interpretations of EU law regarding third



countries market participants' access to the Single Market. Such competition would be detrimental to the mutual trust between supervisory authorities in Europe and would challenge the credibility and the efficiency of the whole EU supervisory system.

As an example, the likely intense technical discussions with the US SEC on the mutual recognition of supervisory regimes, could be efficiently carried out by a dedicated small group of CESR members working with the support of the Review Panel and the Secretariat.

For all these reasons, CESR still wonders about the usefulness of excluding the Level 3 Committees from the EU/US Financial Services Regulatory Dialogue, in which their national US counterpart actively participates.

The above set of proposals could improve the level 3 activities of CESR and facilitate further supervisory convergence effort under the current framework. It should nevertheless not be interpreted as providing CESR with a full capacity to ensure uniform application of the FSAP directives, as long as national discretions will remain, keeping in mind that the primary accountability obligation of the members of CESR is vis-à-vis to their national constituencies.

What is expected from CESR and the cooperation between authorities should be defined in full knowledge of this fact. Additional tasks, further concrete and predictable supervisory convergence will always be confronted with this limit. If the EU Institutions decide that further convergence is necessary, the above outlined steps would be necessary. At the same time many members consider it imperative to reflect on possible future steps.

III. The possible options for an evolution of the Lamfalussy arrangements

As already stated in its previous Himalaya report, CESR is not advocating for the creation of an EU single regulator embedded in the Treaty. The driving force for an evolution of the current arrangement is the degree of integration of the various investment services activities covered by the FSAP. The continuous consolidation trend within the Single market and with the US market are clear signs of this integration.

The following are ideas that the EU institutions could consider if they wish to respond to the current challenges in an evolutionary manner.

In developing this Section III, the members of CESR have not tried to reach a consensus. Two main currents of opinion among members could be distinguished: the first one deems that the present arrangements have to be strengthened and deepened in accordance with the proposals under I and II, without interference with CESR's role and function as a level 3 committee under the Lamfalussy regime, and that these arrangements have not yet delivered all the potential that can be derived from them. The other tendency is rather of the opinion that the limits of realising further convergence are soon to be reached, also taking into account the increasing number of CESR members, and that additional steps have henceforth to be prepared.

However, as the following proposals would require thorough analysis as to their effects, and as an initiative by the European Commission and a political decision by the Council and the Parliament, is in any case required, the members of CESR have, at this juncture simply drawn up a catalogue of possible ways forward on which they have different views.

A. Provide CESR with a real capacity to carry EU projects

Currently, CESR is an advisory committee for Level 1 and 2 legislation and its daily operations are run through a not-for-profit association under French law. Many tasks assigned to CESR are typically only attributed by EU legislation in very general terms. No EU financing is attached to this role. As an example, the transaction reporting exchange mechanism (TREM) under the MiFID has been established without explicit reference in the legislation and CESR has been able to develop this mechanism by having recourse to the reserves, accumulated out of members' contributions during the past years.



Generally speaking some members consider it a paradox that of the four layers under the Lamfalussy approach, the third layer and the daily supervision of markets has no explicit legal basis at EU level. Other members think that the present function of the L 3 committees is to foster common regulatory and supervisory approaches of national competent authorities and to ensure consistent application of FSAP Directives on a voluntary basis which does not require an institutional legal basis under EU law.

In the view of some members an additional step would be confer to some of CESR's Level 3 measures a binding nature. In this context Level 3 measures should be clearly understood as practical measures taken to enhance common practices and facilitate cross-border business. They can be perceived as covering practical application issues, while Level 1 and Level 2 measures should be implemented by legislative or regulatory measures at a national level. In the past, some Level 3 measures led to situations where regulators had to adopt rules to be implemented by national legislation that were beyond their competencies, creating difficulties in terms of accountability. Level 3 measures should be limited to technical measures that fall within the remit of the regulators. Other members think that the real problems of convergence are caused by legal structures created by national law implementing Level 1 and 2 provisions and by the exercise of the manifold options that Level 1 provisions leave to EU-member states. Where CESR members are able to implement CESR's level 3 measures by their own competence these members think that the results of the present arrangements of CESR that are now coming into full operation need to be obtained before any further steps can be suggested.

Finally, according to some members further analysis by the Commission of what is legally possible under the Treaty would be necessary in particular if the EU Institutions intend to give a legal basis to the Level 3 Committees.

B. Provide competent authorities with an enhanced capacity to cooperate

Cooperation between competent authorities is mandated by the directives. However, the provisions differ from one directive to another creating sometimes legal uncertainty on the capacity to cooperate. A harmonisation of the legal obligation to cooperate across the directives would be an added value.

But more importantly, as stressed in Section 2, the capacity for the competent authorities to delegate decisions is extremely limited. More room for the competent authorities to delegate each other supervisory powers would allow the network of supervisors to adapt to market realities they supervise. The risk to be guarded against here is to impose costly duplication of supervision on market participants.

It is CESR's view that time is approaching for a general discussion about delegation of powers. Complex issues will need to be discussed, including: burden and cost sharing, liability, litigation, and possibly, mandatory delegation.

IV. An urgent issue: the financing of EU supervisory convergence

Under the present arrangement, CESR is financed by annual contributions from its members defined according to QMV weighting under the Nice Treaty. The total amount has significantly increased in six years and reached today almost four million euros. For small authorities, the annual contribution to CESR might represent more than 5% of their budget and for authorities from Member States benefiting from a high number of votes but regulating a relatively small market the annual contribution is perceived as unfair.

CESR has therefore reached the limit of what it can finance by itself after six years of free advice to the EU Institutions. It cannot carry additional tasks if their financing is not explicitly specified.

Exploring the possibility of external financing seems unavoidable. Two main options should be considered:



- contributions or financing by EU institutions for certain projects that CESR undertakes in order to create infrastructures for the proper implementation and functioning of the EU directives;
- industry financing should be explored. This exists at national level without undermining the independence of the authorities. It should be also noted that several EU bodies, offices or agencies are partially financed by the players of the private sector they supervise when they provide a service to that industry. Any progress in this direction should be carefully thought out and extensively discussed in order to ensure CESR's independence and avoid that expenditure by industry nationally is duplicated at EU level.

The way in which annual contributions from members are currently defined will most likely have to be reviewed in the future. Indeed, should the Reform Treaty be ratified, the voting rights regime in the Council will be replaced by a significantly different decision making process. CESR would therefore have, to reconsider how the current budgetary burden is shared between its members.

Finally, under the condition that it does not undermine CESR's independence, a number of projects with manifest added value for the EU Single Market could be financed by the EU budget: this includes for example, any new EU-wide IT data sharing arrangements and the training platform for supervisors.