Some legal challenges of financial regulation in the EU[1][2]

Jonathan Faull[3]

Introduction

It is an honour to give the 2011 lecture in memory of a great British and European judge and jurist, Gordon Slynn. His contributions to the development of the law here in the United Kingdom and in the wider European Union were enormous. On a more personal note, Gordon was a man of great charm and he showed me great kindness when, as a young Commission official, I met him on various occasions. He was unfailingly courteous and never stuffy; he always found time to discuss the law with people of all ages and backgrounds. In so doing, he inspired a whole generation of European lawyers in Britain and beyond. The Foundation which bears his name does remarkable work in spreading the rule of law across Europe and that makes it doubly an honour to be here this evening.

---

[1] This is the revised text of the Ninth Slynn Foundation Lecture delivered in London on 7 March 2011.

[2] Given their tasks and the mess they have to clear up, this is dedicated hopefully and with apologies to the late J.D. Salinger to ESMA EBA and EIOPA "with love and squalor". See The New Yorker, 8 April 1950; Penguin (UK), reissued 2010.

[3] Director General, European Commission. The author expresses his personal views in what follows. He thanks his colleagues Raffaella Assetta and Jan Ceyssens most sincerely for their assistance in preparing this lecture. Any errors or infelicities of expression are his responsibility, not theirs.

The financial and economic crisis which started in 2008 has had devastating effects in Europe and elsewhere. Some figures to illustrate the point:

EU countries have planned and had approved measures for the financial sector amounting to € 3.7 trillion, 31.6% of EU GDP, roughly double the UK's annual GDP. € 2 trillion (including bank guarantees) have actually been used for bank bailouts. The destruction of wealth measured by stock market falls between January 2007 and early 2009 amounted to 70% in the financial sector and 50% overall; today the loss in value, compared with January 2007, is about 50% for the financial sector and 30% overall. At the end of 2009, EU GDP was back to the same value as at the beginning of 2006, and in the UK to the value it had in mid-2005. More than three years of economic growth were simply lost. The European Commission, in its "Annual Growth Survey: advancing the EU's comprehensive response to the crisis" (COM(2011) 11 final, 12 January 2011), stated that:

"In spite of the prompt response given by the EU, the legacy of the crisis is far reaching. It has resulted in a large loss in economic activity, a substantial increase in unemployment, a steep fall in productivity, and badly weakened public finances. By the end of 2012, eleven Member States are expected still to remain at output levels below those preceding the crisis. In 2010, EU gross government debt rose, on aggregate, to around 85% of GDP in the euro area and to 80% EU-wide. The budgetary impact of the crisis will compound the effect of demographic change, which will add a fiscal burden of some 4.5% of GDP in the long term. Structural weaknesses that were not tackled before the crisis have become

more apparent and urgent. The crisis has taken a heavy toll on Europe's societies, despite the cushioning provided by welfare systems. The rise of unemployment is a central problem. On aggregate, 9.6% of the working population is unemployed. In some countries, youth unemployment can be as high as 40%. Around 80 million people are estimated to live below the poverty line in Europe."

In the face of these appalling figures and the human failure and misery they represent, it is almost embarrassing to point out that the ongoing crisis has posed challenges to European lawyers as well. Nevertheless, the rule of law remains a bedrock value and a distinguishing feature of the EU. Its institutional and legal systems have survived many crises in their short life and it is essential that they continue to function properly as Europe develops collective responses to today's problems. In what follows, I will consider some of the legal issues that have arisen as the EU has devised those responses.

The financial crisis exposed the shortcomings of supervision of the financial sector in many countries, including EU Member States. Even more worryingly for the EU's burgeoning single market in financial services, cross-border supervision was shown to be weak. The Belgo-Dutch Fortis bank provided a chilling example of a bank with substantial activities and many shareholders in two countries among the closest in the world, co-founders of the EU and of the Benelux which preceded it, sharing a common language and centuries of cooperation in various forms and frameworks. But what did the Belgian and Dutch do when Fortis ran into trouble? They reached for

their taxpayers' pockets, nationalised it, each country separately, and split the bank into two.

In response to the global financial crisis, the European Commission asked a High Level Group, chaired by Mr Jacques de Larosière, to consider how European supervisory arrangements could be strengthened to improve the effectiveness of supervision and rebuild trust in the financial system. Among its many conclusions, the Group recommended that supervisory arrangements should concentrate not only on supervision of individual firms but also on the stability of the financial system as a whole. [4]

In 2009, the de Larosière report recommended, inter alia, that a Union level body be established with a mandate to oversee risk in the financial system as a whole.

On 16 December 2010 the legislation doing just that entered into force: Regulation (EU) No 1092/2010 of the European Parliament and the Council of 24/11/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (the 'ESRB Regulation') and Council Regulation (EU) No 1096/2010 of 17/11/2010 conferring specific tasks upon the European Central Bank concerning the functioning of the ESRB.

The ESRB is part of the European System of Financial Supervision (ESFS), the purpose of which is to organise supervision of the Union's financial system. Besides the ESRB, the ESFS comprises the

[4] Report of the High-level Group on Financial supervision in the EU chaired by Jacques de Larosière, 25.2.2009.

European Banking Authority (EBA, London),[5] the European Securities and Markets Authority (ESMA, Paris) [6] and the European Insurance and Occupational Pensions Authority (EIOPA, Frankfurt) [7].

International efforts have also borne fruit. World leaders have agreed in the G20 on a major overhaul of the way the financial sector is regulated and supervised. The key challenges identified by the G20 – regulating all systemically relevant markets and financial institutions, requiring banks to hold more and better capital, setting up appropriate crisis management frameworks – are challenges also firmly on the EU's agenda.

The integration and regulation of the financial services sector have been part of the EU's work towards a single market for many years. Over time, and certainly since the Financial Services Action Plan of 2000, regulatory convergence has increased considerably. Trends in securities markets have been set and influenced by EU Directives on Prospectuses, Market Abuse, (the delightfully named MAD[8]) and Markets in Financial Instruments (MIFID[9]). Banking capital rules are laid down in considerable detail in the Capital Requirements and Capital Adequacy Directives (CRD and CAD[10]) and its predecessors,

[5] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), OJ L 331, 15.12.2010, p. 12.
[6] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), OJ L 331, 15.12.2010, p. 84.
[7] Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), OJ L 331, 15.12.2010, p. 48.
[8] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), OJ L 96, 12.4.2003, p. 16.
[9] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments, OJ L 145, 30.4.2004, p. 1.
[10] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), OJ L 177, 30.6.2006, p. 1; and

while in the insurance sector Solvency II[11] is at the forefront globally of the move to risk-based insurance supervision. In a single market, Member States are able to create a safer, sounder, more transparent and more responsible financial system only together, not by fragmented and divergent national measures leading to regulatory arbitrage and chaos in dealing with cross-border problems.

Many of the reforms agreed in the G20 require a reconsideration of EU policies: should hedge funds and private equity be subject to prior authorisation and supervision? What level of capital do banks have to hold? How are derivatives traded and cleared? But none of these reforms can reach the objectives set by policy makers if we do not get the legal framework right, if we draft rules that are too rigid or too flexible, or if the institutional setting will not allow supervisors to implement the reforms properly. So today, in front of this distinguished audience, I want to reflect not on the need to regulate hedge funds or to require more banking capital, but on the rules and the institutional settings which the EU is setting up to implement the reforms.

The starting point is that the EU's legal system, which Gordon Slynn did so much to fashion and shape, is fit for purpose. Indeed it has shown itself fit for many purposes as the EU has grown in size and responsibility. The principles and mechanisms devised for a smaller and narrower common market in the 1950s and 60s still work remarkably well in the Union of the 21st century, with 27 countries and activities a long way from coal and steel.

Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast), OJ L 177, 30.6.2006, p. 201.

[11] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) , OJ L 335, 17.12.2009, p. 1.

Setting the rules

G20

The EU's regulatory agenda is broadly inspired and guided by the G20 principles and the technical coordination carried out by the Financial Stability Board and the Basel Committee of Banking Supervisors and its peers in the areas of securities and insurance regulation. The communiqués of successive G20 summits are a common commitment of the world's major advanced and emerging economies to the reform of financial regulation. As financial markets are global in scope, international cooperation among regulators and supervisors, the strengthening of international standards and consistent implementation are necessary to protect against adverse cross-border, regional and global developments affecting international financial stability. That acknowledgement has given rise to agreements such as the commitment at the London summit in September 2008 to ensure that standardised over-the-counter derivative contracts are cleared through central counterparties by the end of 2012, or the commitment at the November 2010 summit in Seoul that the new bank capital and liquidity framework developed by the Basel committee will be translated into national laws and regulations to be implemented starting on 1 January 2013 and fully phased in by 1 January 2019.

The G20 is a self-appointed network, not an international organisation. Its declarations are agreed by consensus. States have not delegated to it formal authority to make, implement or enforce rules. It is very far from the shared sovereignty, institutions and legal system we know in the EU. But it exists and it is all we have.

There is a WTO, a WHO, a WIPO, but there is no WFO for finance or WBO for banking. The G20 brought leaders of the world's largest economies together to forge a common response to the crisis. With its high-level political authority it has proved effective in providing an international response to the financial crisis. Its commitments engage the political responsibility of those who make them.

While there is no formal procedure to enforce G20 commitments, it and the Financial Stability Board (FSB), fortunately and ably underpinned by the Basel system built on the Bank for International Settlements (BIS)[12], have set up mechanisms to follow implementation by means of monitoring and peer pressure. The FSB has established an Implementation Monitoring Network to monitor national implementation of G20 and FSB recommendations and to identify differences and deficiencies together with policy actions to address them. It also carries out thematic and country peer reviews. The former focus on the implementation of policies or standards agreed within the FSB, with particular focus on consistency in cross-country implementation and the effectiveness of the policy or standard in achieving the intended results; the latter concentrate on the implementation of financial sector policies and standards in a specific jurisdiction. In respect of adherence to supervisory and regulatory standards, the FSB is tasked with identifying jurisdictions not cooperating fully with its evaluation process or showing insufficient progress in addressing weak compliance with internationally agreed information exchange and cooperation standards.

[12] For a telling and entertaining account of the origins of the BIS, see A Liaquat, The Lords of Finance: The Bankers who Broke the World, Penguin, January 2009,

Of course these arrangements do not have the bite of the dispute settlement mechanisms found in other areas of international economic law such as the WTO or international investment agreements, let alone the enforcement systems of EU law. But they do make it clear that there is a strong expectation that G20 members will respect their commitments and attach some consequences to non-compliance. Encouragement from peers has proven effective in causing all countries and jurisdictions to raise their level of adherence to international financial standards.

G20 commitments may also take on legal relevance as part of the context for the interpretation of international treaties. WTO panels or international investment arbitration panels should take them into account when deciding whether conduct in the area of financial services is bona fide compliance with regulatory requirements or an unjustifiable violation of treaty provisions. That said, G20 commitments are not hard and fast law. That will be the case when they are enacted by domestic law.

A Single Rule Book for financial services

EU rules have a major role to play in this context. The EU can give G20 commitments the force of law across Europe and ensure that the reform agenda does not lead to market fragmentation. But this requires that EU rules interact with national law in the most effective way. Unfortunately it is still the case that Europe suffers from a lack of a consistent set of rules and standards governing financial institutions. The report presented in 2009 by the de Larosière Group[13] identified several areas where new regulatory measures

[13] Report of the High-level Group on Financial supervision in the EU chaired by Jacques de Larosière, 25.2.2009.

were needed to protect consumers and restore financial stability and sustainable economic growth. While regulatory repair was needed in all major jurisdictions around the world, the de Larosière report pointed to the lack of a consistent set of rules within the EU as an additional challenge for Europe. That lack of consistency is due to differences in the national transposition of EU law stemming from exceptions, derogations, additions or ambiguities in current directives and national choices in the face of minimum harmonisation.

Several directives in this field have left Member States significant options and discretion. For example, the Capital Requirement and Capital Adequacy Directives (2006/48/EC and 2006/49/EC) provide for about one hundred options and discretionary choices for Member States. By option I refer to a situation where Member States are given a choice on how to comply with a given provision selected from alternatives set out in the Directive. For example, Member States may choose between two methods for risk-weighting exposures to credit institutions: on the basis of the risk-weight of the corresponding central Government or the credit assessment of the institution itself. Discretion refers to a situation where Member States are given a choice as to whether to apply a given provision. For example, Member States may decide that, if certain conditions are met, some subsidiaries need not be included in consolidation.

In addition, the transposition of directives has led to divergent national measures. One of the reasons is the "gold plating" practice of some Member States which have added sometimes far-reaching national rules to a directive's requirements. For instance, in the transposition of the Insurance Mediation Directive, some Member

States have introduced additional information requirements (provision of a risk-sheet or disclosure of fees received by the intermediary) or stricter qualification requirements (possession of previous experience, training…). Even when implementing measures are limited to the minimum necessary to comply with the Directive, divergences arise because of ambiguities or interpretations that the national legislature may have introduced, deliberately or otherwise.

In many cases these regulatory divergences are no longer sustainable. The EU needs a core set of fully harmonised rules, a European single rule book for financial services. Banks and insurance companies need to be subject to the same capital rules, regulated markets to the same transparency requirements and market conduct to the same standards. The subsidiarity principle is rightly a tough test for any such project to promote further convergence in EU rules. I believe that a European single rulebook does pass the test – it achieves what cannot be properly achieved at Member State level.

Without a single set of rules, Member States are not able to prevent regulatory competition and arbitrage to the detriment of financial stability. The financial crisis revealed cases where banks exploited the single market's opportunities to offer services from jurisdictions where deposit guarantees were less onerous – leading to major problems when banks failed, with the settlement of claims still being negotiated today. The financial crisis also exposed cases where supervisors exercised forbearance in favour of their banks for fear of damaging their competitiveness – leading to billions of pounds of taxpayers' money being spent on bailouts.

The merits of regulatory competition have been debated for decades. [14] A related debate, heard most often in this country where the City of London and other financial centres are engaged in trade and competition all over the world, is that Europe is too small a setting for regulation. All the problems of arbitrage I have mentioned, if eliminated in Europe, remain unaffected elsewhere. The G20 is all very well, but it is not the EU writ large. Indeed it is not, but that reality is not a reason for doing nothing. The EU's mandate is to build and sustain a single market and in that area, containing many of the world's greatest financial institutions and markets, regulatory reform which takes account of competitive conditions in the rest of the world can restore confidence and growth, while contributing to wider international efforts.

Without a single set of rules, we will not manage to restore investors' and consumers' confidence in the European financial system. Only a single rulebook can reduce discrepancies in risk assessment and make financial institutions truly comparable and transparent for investment decisions. Recent EU stress tests have shown that applying common criteria will make risk assessments more credible and more reliable for investors and consumers. Similarly, without a single rulebook, we will not be able to create true mutual trust and improve cooperation between supervisors. How can one expect national supervisors to cooperate with each other in resolving a cross-border banking group when some of them do not even have the power to put parts of the group into a bridge bank? A single European rulebook should provide a common legal

[14] See eg DC Esty and D Geradin, Regulatory Competition and Economic Integration: Comparative Perspectives, Oxford University Press, 2001; Dale D. Murphy, The Structure of Regulatory Competition: Corporations and Public Policies in a Global Economy, Oxford University Press, 2004.

basis for supervisory action in the EU. It can also be expected to consolidate and strengthen the integration of EU financial markets by bringing down costs for cross-border financial institutions, which will face the same rules throughout the EU/EEA and by strengthening consumer confidence in the financial sector: the public will know that, wherever in the EU a bank is based, it has to respect the same safety standards.

A single rule book does not mean full harmonisation of all rules. It entails a harmonised core set of standards, applied in a harmonised manner throughout the EU by all supervisors. It will not replace supervisors' exercise of judgment and force them into a one size fits all approach. It is a key lesson from the crisis that supervisors need to apply judgement, assess each bank's business model and take tailor-made measures. If a bank's risk profile is unusually high, supervisors should be able to require that it hold more and/or better capital. The judgement, assessment and measures will be different depending on the circumstances of the case, but the basic rules themselves should be the same whether a bank is incorporated in the UK or Iceland, Germany or France.

It is in light of such considerations that the European Council called in June 2009 for the establishment of a single European rule book applicable to all financial institutions in the Single Market. The key purpose of the single rule book is to eliminate inconsistencies, conflicts, duplication and ambiguities in European directives and regulations, and national provisions Implementing them, to ensure more coherent regulation of the EU's financial sector. A single rule book requires first of all that EU legislative acts be clarified and

options and discretions removed, especially in areas where there are difficulties in implementing legislation because of successive amendments, overlapping or conflicting requirements, or where there is legal uncertainty resulting from inconsistent definitions or terminology. It should avoid gold-plating by preventing Member States from imposing additional requirements and ensure that all financial markets, products and participants are subject to a set of harmonised core rules ("maximum harmonisation" approach). This means that EU common rules have to be more detailed than those resulting from the more traditional mutual recognition and minimum harmonisation approach. Along with common legislation, common standards are needed for the consistent application of the law. The new European Supervisory Authorities will play a key role in this respect by developing common technical standards which are to become legally binding after endorsement by the Commission

The degree of harmonisation is an issue for consideration and debate in every case, but the general objective of the single rule book will be to harmonise financial services rules to the greatest extent possible. EU legislation in this field has become sufficiently mature to make maximum harmonisation possible.

Finally, we have to consider whether directives are the appropriate instrument to create a single rule book. Regulatory convergence in the EU has mainly been achieved by way of directives. Over time directives have become more and more detailed and prescriptive.

For example the EU's capital requirements directive contains eleven annexes and about 230 pages of detailed rules on how banks have

to calculate their capital, implementing the international consensus reached in the Basel Committee of Banking Supervisors. However detailed a directive may be, it always requires transposition into national law, an exercise that was supposed to allow insertion into national law in accordance with national choice of method. Confronted with a long, detailed directive, can this be more than a simple copy-paste exercise? Even though the ECJ has developed its case law on direct effect,[15] it is questionable whether investors or consumers will be able to rely in legal action against a bank on prudential and market conduct requirements contained in directives addressed exclusively to Member States.

Against this background, the use of regulations for the development of a single financial rule book has several advantages. Regulations are directly applicable in all Member States. They provide the best way to achieve uniformity and predictability throughout the EU. The rules can enter into force immediately in the same way and on the same date in all Member States. Regulations create rights and obligations enforceable before national courts. They therefore

15 The Court has held in a series of cases that unconditional and sufficiently precise provisions of a directive could be relied on against a variety of public authorities and bodies, including local or regional authorities (Case 103/88 *Fratelli Costanzo* v *Comune di Milano*, [1989] ECR 1839, paras. 30-31), public authorities providing public health services (Case 152/84 *Marshall* v *Southampton and South-West Hampshire Area Health Authority*, [1986] ECR 723, para. 48) or bodies, whatever their legal form, which have been made responsible for providing a public service under the control of the State and have for that purpose special powers beyond those which result from the normal rules applicable in relations between individuals (Case C-188/89, *A. Foster and others* v *British Gas plc*, [1990] ECR I-3313, paras. 18-20). The Court has further broadened the scope for direct effect by applying it in a series of cases between private parties, as long as no legal obligations are imposed on individuals (see Case C-194/94, *CIA Security* v *Signalson*, [1996] ECR I-2201, paras. 44-45; Case C-443/98, *Unilever Italia* v *Central Food*, [2000] ECR I-7535, paras. 45-52.

strengthen private enforcement of Union law and ensure that policy is given the same effects in all parts of Europe's single market.

Directives have to be transposed into national law. Transposition has the advantage of integrating EU rules into the national legal framework. It usually requires legislative work at national level, which may be quite complex and time-consuming. Although changes in national law may be necessary in some cases even with regulations, for example to lay down responsibilities and procedures for national authorities, this is much less onerous than the full transposition of a directive.

The transposition process can also create difficulties for the quick responses needed in times of crisis and to implement G20 commitments within the deadlines to which the EU is committed. The use of Regulations would facilitate timely and uniform implementation of commitments at international level by all Member States and strengthen the EU's position and credibility in talks and negotiations with other countries (e.g. mutual recognition agreements).

At the same time, directly applicable rules do not mean "one size having to fit all". Uniform rules are not incompatible with a certain degree of flexibility for national supervisors in the application of the rules. Furthermore, regulations do not necessarily provide for full harmonisation of all aspects of a particular issue but may be limited to some key matters. Where necessary, a regulation can be as flexible as a directive

For all these reasons, the Commission believes that, wherever possible, regulations instead of directives should be adopted when creating new EU rules and when revising existing legislation in the area of financial services most relevant for resolving the current crisis.

Challenges for a single financial rule book

A single rule book cannot be created in a day, but we are making progress, for instance with the adoption of a new set of rules for managers of alternative investment fund managers, with the introduction of strict authorisation requirements for credit rating agencies and the Commission's proposals for regulations on short selling and derivatives.

Much remains to be done and the legislative programme will need openness and a constructive attitude from all parties. For its part, the Commission is working on the review of several key directives in 2011 (MAD, MIFiD, CRD IV...) and, in all its forthcoming initiatives, it will consider the appropriateness of proposing regulations to create the single rule book.

Drawing up a single rule-book for financial markets must take account of the rich diversity of situations in the EU. National retail financial markets and the infrastructure supporting them differ widely, due to differences in national habits and laws, pension provision, health and social services, patterns of savings and investment, levels of product choice, consumer knowledge and appetite for risk. A rule addressing foreseeable problems in one or

two Member States could be unnecessary or disproportionate in others. This requires a careful assessment of the appropriate level of harmonisation in different sectors.

Coordinating the supervisors

The best rule book is useless if it remains unread and unapplied. The EU's rules must be implemented and enforced consistently by the supervisory authorities in all countries. I now turn therefore to the institutional setting of financial supervision. The de Larosière Group recommended the creation of a more integrated European supervisory system as an urgently needed measure.

Why did the EU need a new supervisory architecture? Firstly, because supervisors and regulators lacked a 'big picture' view of the world. A focus on individual firms obscured the systemic risks building up in the background. Secondly, and in particular in Europe, financial market integration outpaced the mechanisms we had in place to monitor risks. Supervision was too national, while markets and institutions were becoming international – for example the wholesale banking market in the euro area doubled in size between 1999 and 2006. This disconnect between European and global financial integration and local supervision created increasing risks of regulatory arbitrage and failure.

Finally, when the crisis erupted, supervisors were insufficiently prepared and resourced, unable to coordinate responses with each other to the degree needed and lacked mechanisms to share crucial

information.

Financial supervision relies essentially on the skills, knowledge and experience of supervisors who know banks' businesses inside out. But the crisis had shown that a simple forum for discussion between supervisors such as the Committee of European Securities Regulators and its peers was insufficient when hard decisions had to be taken. Only a body with the power to back up requests for coordination with binding decision-making powers would be able to provide effective coordination of supervisors and consistent application of rules across the EU.

The European Supervisory Authorities (the ESAs) are, as we have seen, the European Banking Authority based here in London, the European Securities and Markets Authority in Paris and the European Insurance and Occupational Pensions Authority in Frankfurt. Together with the European Systemic Risk Board, they are Europe's response to the challenge of creating consistent supervision and effective coordination backed up by binding decision-making powers, while leaving day-to-day supervision nine hands of national supervisors. A further legal challenge, of which more later, is how to empower these authorities to act decisively, while respecting the EU's constitutional requirement that they should not enjoy discretionary powers.

The ESAs' powers in the EU Treaty framework

No article of the Treaty on the Functioning of the EU provides an explicit legal basis for an EU policy regulating financial services or financial stability. But EU directives coordinating national banking

laws to ensure the freedom of establishment and the freedom to provide services (Articles 53 and 62) have existed for many years, as have EU measures approximating financial services rules as part of the establishment and functioning of the internal market (Art 114 TFEU). This is not surprising given the importance of financial markets operating in the United Kingdom and other Member States. Financial market integration in the EU has brought substantial economic benefits and a single market is scarcely conceivable without stable financial institutions, integrated payments sysyems and securities markets. The EU's Treaties do not provide explicitly for the creation of financial supervisory authorities, but they have been set up by regulations adopted by the European Parliament and the Council of Ministers pursuant to powers conferred by the Treaties.

This brings us to a key question. To answer it, we have to go all the way back to 1958. Can actual decision-making powers be delegated to an independent Authority? The Court of Justice's judgment of 13 June 1958 in Case 9/56 is one of the lasting legacies of the European Coal and Steel Community and the Treaty of Paris which created it, a Treaty expired and little studied today, but still the foundation stone of the European integration project. What did the Court say and why?

The issue is a familiar one. Delegating powers to bodies which are neither elected nor under the direct control of elected officials is a problem in a democracy[16]. The Meroni judgment in 1958 is the

[16] This is a familiar issue for US lawyers too. In the related minefield of US post-financial crisis law, see C. Boyden Gray and J Shu, *The Dodd-Frank Wall Street reform & Consumer Protection Act of 2010: Is it*

locus classicus in EU law on circumscribing the delegation of powers. In that case, the High Authority of the European Coal and Steel Community had delegated to an industry association the determination of certain steel levies. The Court of Justice held that this violated the Treaty. It held first of all that an authority cannot delegate "powers different from those which the delegating authority itself received under the Treaty" and that "a delegation of powers cannot be presumed and even when empowered to delegate its powers the delegating Authority must take an express decision transferring them".

The Court went on to distinguish two types of delegation: “the consequences resulting from a delegation of powers are very different depending on whether it involves clearly defined executive powers the exercise of which can, therefore, be subject to strict review in the light of objective criteria determined by the delegating authority, or whether it involves a discretionary power, implying a wide margin of discretion which may, according to the use which is made of it, make possible the execution of actual economic policy”. According to the Court, “a delegation of the first kind cannot appreciably alter the consequences involved in the exercise of the powers concerned, whereas a delegation of the second kind, since it replaces the choices of the delegator by the choices of the delegate, brings about an actual transfer of responsibility” and is therefore not compatible with the Treaty.[17]

Constitutional? (2010) 11 Engage, 66-74, available at http://www.fed-soc.org/doclib/20101223_GrayShuEngage11.3.pdf.

[17] Case 9/56, *Meroni v High Authority*, [1958] ECR 11 at 149-152.

Subsequent judgments have shown that this standard, which was developed more than 50 years ago, is still good law.

In *Tralli v ECB*[18], the Court confirmed that "the powers conferred on an institution include the right to delegate, in compliance with the requirements of the Treaty, a certain number of tasks falling under those powers, subject to conditions to be determined by the institutions". It also reiterated that "a delegating authority cannot confer (...) powers different from those which it has itself received", and added that the exercise of the powers by the delegate "must be subject ot the same conditions as those to which it would be subject if the delegating authority exercised them directly" and that "the delegating authority must take an express decisions transferring them and the delegation can relate only to clearly defined executive powers". The Court applied these principles to the delegation of internal rule making powers by the ECB to its executive board, which it found to be lawful.

In *Alliance for Natural Health v Secretary of State for Health*, [19] the Court applied the Meroni principles in assessing the validity of a directive which delegated certain powers to the Commission to modify a list annexed to the directive. It held that a power can be delegated only if it is "clearly defined and (...) the exercise of the powers is subject to strict review in the light of objective criteria".

In *FMC v EFSA*[20] the Court considered the powers of European Food Safety Authority in the light of Meroni principles, confirming that a

[18] Case C-301/02 *P. Tralli* v *ECB*, judgment of 26 May 2005, [2005] ECR I-4071, paras. 41-46.
[19] ECJ, Joint Cases C-154 and C-155/04, Alliance for Natural Health v Secretary of State for Health, judgment of 12 July 2005, [2005] ECR I-4071, para 90-39.
[20] ECJ, Case T-311/06, FMC Chemical and Arysta Lifesciences v EFSA, Order of 17 June 2008, parar 66.

delegating authority "even when empowered to delegate its powers, (...) must take an express decision to that effect".

So Meroni is still the standard against which delegation must be judged and the Parliament, Council and Commission have spent considerable time and effort to ensure the ESAs' institutional set-up respects the Treaty and the Meroni principles in particular.

Consider, for example, the power of the new Authorities to develop binding technical standards on the application of EU rules which national supervisors are obliged to follow. Such common standards are essential to ensure that all supervisors apply EU law in a consistent way – non-binding guidelines issued by the so-called Lamfalussy committees, the ESAs' predecessors, were ignored all too often. But the Authorities do not have rule making powers – under the EU Treaty such powers cannot be delegated to agencies. It is only to the Commission and, in some limited circumstances, to the Council that power can be delegated to adopt delegated acts – non-legislative acts of general scope – or implementing acts – ensuring uniform application of EU rules – under Articles 290 and 291 of the TFEU. It is therefore the Commission which issues the binding technical standards developed by the new Authorities. Some may see this as an imperfection in the quest for supervisory autonomy – but it goes as far as possible in the framework of the EU Treaties.

With one exception, credit rating agencies, the new Authorities do not carry out day-to-day supervision. That is the business of national supervisors. But just as a law is a dead letter without courts to enforce it in specific cases, a technical standard would not ensure

truly consistent supervision and loyal cooperation between supervisors if the new Authorities could not look at specific cases to check proper application. Accordingly, the new Authorities have the power to intervene in specific cases if supervisors breach EU law, cannot settle disagreements, or need to act together in emergencies.

Let us look at the ESAs' intervention powers to settle a disagreement. If supervisors of a cross-border banking group refuse to exchange the necessary information, or if the home supervisor of such a group remains inactive in spite of clear evidence that a bank operating under the EU passport in other Member States is breaching prudential rules, each supervisor concerned can raise the matter with the ESA which will be able to settle the matter by way of a binding decision to ensure compliance with EU law. The powers of the ESAs are limited to ensuring compliance with EU law. Any supervisory action on the ground will normally be taken by the national supervisory authority, which is bound by the ESA decision on EU law but entirely free in the lawful exercise of supervisory judgement. Only if a national supervisor fails to act as required by law and by the ESA decision, can the ESA address decisions direct to financial institutions as a last resort and only in areas covered by directly applicable EU rules. You see that there are a lot of belts and braces built in to ensure that day-to-day supervision over City banks is exercised from Canary Wharf or Threadneedle Street, rather than from Old Broad Street where the EBA is based. But if ,heaven forbid, a national supervisor were wilfully to disregard the binding nature of EU law, as a last resort the EBA could ensure compliance by issuing direct decisions to financial institutions.

We do not expect this to happen, but the mere fact that this possibility exists should ensure that no national supervisor will simply ignore ESA decisions and EU rules until markets have moved on - and that supervisors playing by the rules can be sure that their peers in other Member States do the same. The ESAs' powers in emergency situations will be triggered by a Council decision and are limited to ensuring coordinated action between supervisors. There is a special procedure available for Member States in case they fear that the ESAs are impinging on their fiscal responsibilities, raising the matter ultimately for decision by the Council.

The ESAs' powers to supervise and sanction Credit Rating Agencies are circumscribed executive powers. The ESAs will authorise CRAs meeting the conditions laid down in the law. They will take supervisory measures if those conditions are not met and they will apply clearly defined sanctions in case of certain breaches of the rules.

These powers are executive in nature, clearly defined, triggered on request and limited to what is needed to settle the matter raised by the supervisor. So we are confident of Meroni-compliance. The new supervisory structure fully respects the Treaty, but will it be effective? Or have the Meroni principles limited powers too much, made procedures too cumbersome and safeguards too broad? For several reasons I think this is not the case.

First, the ESAs are not designed to create a European Super-Supervisor, but to encourage national authorities to work better together. Their powers fall far short of those of national supervisors, as do their resources in many cases. But the ESAs' success will not

depend on more staff or greater powers, but on whether they will be able to engage national supervisors in a joint project, making European financial markets as a whole more safe and stable. From that perspective it is for example provided that the ESAs' Boards of Supervisors bring together national authorities' top leaders at least twice a year.

Second, the ESAs will have access to all relevant information and will be able to see the full picture that was lacking to many national supervisors during the crises. The ESAs will be able to participate in the colleges bringing together national supervisors of cross-border groups. They will have access to supervisory information held by national supervisors, and – if need be – to request such information from market participants.

And third, formal powers matter even where they are subject to heavy procedural safeguards and are unlikely to be deployed very often. The mere fact that the ESAs do have binding decision making powers will ensure that they are taken seriously in Europe and beyond.

The new ESAs have just selected their chairs and executive directors, and I am confident that they will be able to make a true step forward in the supervisory coordination that we so much need in the EU's internal market, working with national supervisors.

Conclusion

Financial supervision failed in part because supervisors focused on individual institutions' risk and not on systemic risk. They did not see quickly enough signs that many financial institutions were taking

aggressive risks without proper risk management. The regulatory framework was inappropriate: it did not prevent opaque financial operations and products in the financial markets and it allowed financial institutions to neglect risk management.

We must do better. In the EU, that means that we need regulatory reforms to enhance transparency, resilience and stability of financial markets, to protect consumers and investors and restore their confidence in the financial sector. We need to do this work in line with a coherent international approach, as global financial markets require coordinated action.

We will not succeed without the right legal framework or if the institutional setting will not allow supervisors to implement the financial reforms properly.

First, we must give the European Union a single set of rules to reduce regulatory divergence. A single rule book for financial services will provide a core set of harmonized rules, with the flexibility needed to preserve the supervisors' exercise of judgment and to take account of the diversity of situations in the EU. Second, we must ensure that the rule book does not remain unread and unapplied. We have put in place a new supervisory architecture which will be able to monitor the functioning of financial markets and the effective enforcement of EU rules. The new European authorities will coordinate the activity of national supervisors and will develop standards for more consistent implementation of EU legislation. Those authorities have significant powers, but none of them can be considered a "discretionary power implying a wide margin of discretion".

The law is serving the need of the economy and society across all Member States. Gordon Slynn would not be surprised to see the law at work in this way. He would recognise the concepts and mechanisms he did so much to develop and explain.