Politics and the Creation of a European SEC:
The Optimal UK Strategy – Constructive Inconsistency

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Abstract

This paper analyses the factors influencing whether a European Securities and Exchange Commission (ESEC) will be created and confirms the primary role that politics will play in its establishment. In the face of growing support for an ESEC, the paper recommends a strategy the UK should adopt towards the creation of such an institution. It is proposed that the UK adopt a three-pronged approach. First, the UK must, as it currently does, support the Lamfalussy Process in the hope that it works. Second, the UK must determine what criteria need to be assessed in order to evaluate whether the Lamfalussy Process together with the Financial Services Action Plan are in fact harming UK interests, and then make such an evaluation. Finally, if political support for an ESEC becomes unstoppable, the UK should negotiate for the creation of an appropriately structured ESEC – even though its backing for the Lamfalussy Process should logically preclude its support for any type of ESEC. A key attribute of the recommended strategy is thus that it is inconsistent. This is not, however, thought a problem. On the contrary, given that the creation of an ESEC is the stuff of politics and thus that a political response is called for, and given that other key participants' policies on the creation of an ESEC are themselves inconsistent, the strategy proposed is argued as being not only constructive, but indeed rational.

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Introduction

Public policy in the EU is determined by the profane trinity of economics, law and politics – but amongst these three, it is politics that matters most. This paper analyses the factors influencing whether a European Securities and Exchange Commission (ESEC) will be created and confirms the primary role that politics will play in its establishment. In the face of growing support for an ESEC, the paper recommends a strategy the UK should adopt towards the creation of such an institution. A defining characteristic of the strategy is that it is inconsistent. This is not, however, thought a problem. On the contrary, given that the creation of an ESEC is the stuff of politics and thus that a political response is called for, and given that other key participants' policies on the creation of an ESEC are themselves inconsistent, the strategy proposed here is argued as being not only constructive, but indeed rational.

The paper is composed of six sections. In the first, a summary is provided of two central elements of the current environment that affect the decision about the creation of an ESEC: the Lamfalussy Process and the Financial Services Action Plan (FSAP). In section two, key elements of a pivotal report prepared by the Committee of European Securities Regulators (CESR) examining the future structure of supervision in the EU (the "Himalaya" Report) are outlined. In the third section, various current UK perspectives on the merits of an ESEC are described. In section four, the main political factors affecting the creation of an ESEC are examined. In the fifth section, the optimal strategy the UK should adopt towards the creation of an ESEC is discussed. Conclusions are presented in the final section.

1. Current Environment

Two central elements of the current environment that affect the decision about the creation of an ESEC are summarised in this section: the Lamfalussy Process, and the Financial Services Action Plan (FSAP).

Lamfalussy

The Lamfalussy Process was initiated to respond to a series of problems identified by a

group of "Wise Men" – established by the EU's Economic and Finance Ministers and chaired by Baron Alexandre Lamfalussy – with the way securities markets were being regulated in Europe.[1] The main problems the Wise Men found were that: the EU legislative system was too slow, there was no mechanism to update Directives in a timely manner, there was insufficient consultation and transparency in the legislative process, there were too many delays in the transposition and implementation of EU Directives by Member States, there were deficiencies regarding regulatory obligations to cooperate, and many Directives did not focus on core principles and were excessively detailed.

The Lamfalussy Process may be thought of both as a policy approach for allocating various public duties concerning the legislation and regulation of the securities markets at the EU level, and as the set of institutional arrangements necessary to deliver these public duties. The policy approach defines four Levels. Level 1 is intended to consist of framework or essential legislative acts, namely Directives or Regulations, which are decided by normal EU legislative procedures, typically the Co-Decision process.

At Level 2, the European Commission together with the European Securities Committee (ESC) and CESR, define, propose and decide on the technical implementing measures to Level 1 Directives and Regulations. The intention is that Level 2 implementing measures should be used to ensure that technical provisions are kept up to date with market and supervisory developments. The ESC is composed of Member State nominees representing their respective economic and finance ministries, and is chaired by a representative of the European Commission. CESR is composed of senior representatives of national regulatory authorities designated by the Member States. It is required to act in a fully transparent way, consulting market participants, consumers and end-users. The Commission is represented at all meetings of CESR, and is entitled to participate in its debates.

The nature and extent of the technical implementing measures to be taken at Level 2 are specified in Level 1 Directives and Regulations. Such amendments are enacted according to the so-called "Comitology" rule-making procedure.[2] The ESC acts in both an "advisory" and a "regulatory" capacity. In its advisory capacity, the ESC advises the Commission on issues relating to the adoption of proposed Level 1 Directives and Regulations under the Co-Decision process. In its regulatory capacity, the ESC votes on Level 2 implementing measures proposed by the Commission.

The Commission, after consultation with the ESC, asks CESR to prepare technical advice on Level 2 implementing measures. CESR then invites interested parties to provide submissions on relevant issues, and consults with market participants, consumers and end-users at a sufficiently early stage to be able to take their responses into account. CESR may also establish consultative working groups where appropriate. After the consultation procedure, CESR draws up its final

advice and sends it to the Commission. The Commission then presents a proposal for technical implementing measures to the ESC, taking into account the technical advice of CESR. The Commission ensures that the European Parliament is fully informed about these proposals in order to check that the proposals are in conformity with the scope of the implementing powers defined at Level 1. After the ESC has approved a proposal from the Commission, the technical implementing measures are formally adopted by the Commission.

The main objective of Level 3 is to ensure consistent, timely, common and uniform implementation of Level 1 and 2 legislation in Member States, via enhanced cooperation and networking among national EU securities regulators. Level 3 is the responsibility of the Commission, assisted by both the ESC and CESR. CESR seeks to produce guidelines for administrative regulations to be adopted at the national level, to issue interpretative recommendations and set common standards regarding matters not covered by EU legislation, to compare and review regulatory practices to ensure effective enforcement throughout the Union and to define best practice, and to conduct periodic peer reviews of administrative regulation and regulatory practices in Member States. The heart of CESR's mission is an obligation to deliver convergence of policy, supervision and enforcement.[3]

The aim of Level 4 is to strengthen the enforcement of Community rules. If the Commission considers that a Member State has failed to fulfil an obligation under the Treaty of Rome, it is required to deliver a reasoned opinion on the matter after giving the Member State the opportunity to submit its observations. If the Member State does not comply with the opinion within the period laid down by the Commission, the Commission may bring the matter before the European Court of Justice.

FSAP

The FSAP is a program the European Commission adopted in 1999 in order to improve the single market in financial services. It contains forty-two legislative measures to be implemented by 2005 that are divided into four broad areas: retail markets, wholesale markets, prudential rules and supervision, and other miscellaneous areas.[4] By 7/2005, thirty-nine out of these measures had been adopted.

Without going into the details of the FSAP, two aspects of it are noteworthy in this context. First, it has been an enormous legislative program undertaken in a relatively short amount of time, and has consumed considerable public and private sector resources to achieve.

Second, the merits of the FSAP to date are hard to assess. The European Commission recently summarised its views on this topic as follows.[5] In terms of the delivery of legislative measures on schedule, the FSAP was thought to have been a resounding success. It has also

"witnessed a 'culture' change in EU financial rule-making", so that a "new cooperative dynamic between the Commission, Council and European Parliament has paved the way for consensus on sound regulatory solutions within reasonable time-frames". The FSAP has also "seen the bedding down of enlightened new approaches to promulgating EU financial legislation" as advocated in the Lamfalussy Process. The Commission was, however, much less firm about the commercial and economic implications of the FSAP:

> In contrast to its obvious legislative and institutional legacy, the jury is still out on whether the FSAP is significantly improving cross-border commercial opportunities for financial institutions and investors. The Commission's "financial integration monitor" report … provides a first comprehensive body of empirical material describing changes in the level of cross-border integration in key financial segments over recent years. It records some increase in the integration of financial markets and of upstream value-chain functions, corroborating qualitative feedback from the expert groups. The financial integration monitor also describes developments in terms of competition, efficiency and the intensity of cross-border risk transmission channels. However, it remains difficult to determine the extent to which ongoing changes in the EU legislative framework – as opposed to other significant structural developments such as the introduction of the euro, cyclical factors or technology – have contributed to these outcomes…

2. The Himalaya Report

With the publication of its Himalaya Report in 10/2004, CESR re-ignited the debate about how the EU securities markets should be supervised in the future.[6] The report had two main stated purposes: "to take stock of progress made through the FSAP for the integration of the EU Single Market for Financial Services in the field of securities," and "to identify and analyse the supervisory tools necessary to implement the FSAP and to anticipate the expected evolutions in the next five years so as to allow securities regulators to fully play their role in maintaining fair, transparent and secure securities markets in Europe".[7] In the report, CESR explicitly sought not to provide definitive conclusions about how the supervisory structure in the EU should be organised, but rather to present a preliminary analysis of current challenges and possible solutions. CESR also recognised the limits of its legal mandate, and stressed that it was not looking to usurp the powers of the EU Institutions (namely the Council of Ministers, the European Parliament and the European Commission) in determining what the future supervisory structure, including its own role, should be. The key elements of the Himalaya Report are outlined in this section.

CESR observed that the degree and speed of integration across different segments of the EU securities market varied greatly, and argued in response that the appropriate supervisory tools to be adopted at the EU level would need to be different across the different segments. It proposed that a broad three-step approach be employed in adopting the necessary supervisory tools. The first and immediate step would be to realise the role of CESR as specified under Level 3 of the Lamfalussy approach and to implement the supervisory tools provided by the FSAP. The second step would be

to intensify the capacities of the Network of Member State securities regulators (operating under CESR) by deepening cooperation between them, and by developing a rigorous policy to enhance the role of CESR as a "supervisor of national supervisors" through "peer pressure" and a mediation mechanism. The third step would be to explore the possibility that the Network be provided with additional legal and supervisory tools.

The first step of realising the role of CESR under the Lamfalussy approach and implementing the supervisory tools provided by the FSAP is not examined here, as it seeks solely to build on the existing supervisory structure.[8] In order to deliver the second step, namely to intensify the capacities of the Network, CESR proposed adaptive improvements to the Network in four areas: 1) convergence in supervision, enforcement and decision-making, 2) fair implementation and application of Directives, 3) the definition of a mission statement for EU regulators, and 4) EU-wide access to regulatory information. In each of these areas, CESR identified some new supervisory tools which could be adopted in the near future, and others which could be adopted later, subject to developments in the market.

The full list of suggestions CESR put forward for each of the above four areas is not presented here. However, in order to provide an example of the types of recommendations CESR made, the tools it suggested to achieve supervisory convergence are noted. CESR proposed that three ideas should be considered in the near future: the definition of a 'coordinating' supervisor on a case by case basis by the relevant supervisors, a more ambitious policy of secondment of staff between CESR members, and the specification of the role of regulators in the management of identified crises. CESR also put forward two suggestions that might be activated later: a discussion at CESR level of supervisory programs by its members so as to set priorities and allocate resources accordingly, and the creation of a standard Memorandum of Understanding for the supervision of trans-European market participants.

One crucial recommendation CESR put forward concerned the fair implementation and application of Directives. CESR observed that securities regulators across the EU have a diversity of powers both in terms of scope and their rule making, supervisory and investigative means, and that the resources devoted to supervision, the manner in which these resources are deployed, and the degree of autonomy of supervisors in allocating their resources, vary widely across the EU. It noted that together these factors are leading to greatly different supervisory results faced by market participants across the EU. CESR then argued that an EU supervisory system based on the mutual recognition of decisions by national regulators needs mutual reliance and confidence between competent authorities across the EU in the day to day application of the FSAP Directives. It concluded that in order to enhance such mutual reliance and confidence, competent authorities across the EU must have equivalent powers to supervise, must apply the same supervisory intensity

to the same issues, and must also benefit from equivalent financial and human resources.

The third broad step CESR recommended in order to adopt the necessary supervisory tools in the EU was to explore the possibility that the Network itself be provided with additional legal and supervisory tools. CESR stressed, however, that this should only be done if all possible tools under the current legal framework had been fully exploited, and in particular only if it is very clear that the present system cannot be developed to provide proper solutions to the questions of supervisory convergence. If this were done, nevertheless, and accepting the difficulties of predicting the speed and intensity of integration in the Single Market, CESR contended that:

> it cannot be excluded that there could be cases where the tools available to CESR and its Members could be complemented, in certain circumstances, by the legal possibility for the Network, rather than an individual member through mutual recognition, to take single EU decisions.[9]

Before even considering the adoption of "a single EU decision" by the Network, CESR recommended that the following five criteria all be satisfied:

> **Efficiency**. There should be demonstrable evidence that the existing and improved tools of the Network does not allow for an efficient supervision or predictable and legally certain decisions for market participants and investors. (This should include a costs effectiveness and cost-benefit analysis, including resources);
>
> **Subsidiarity**. There should be demonstrable evidence that for decisions that affect the vast majority of Member States it is more cost/efficient to take one single EU decision for the matter involved rather than one mutually recognised decision nor 25 coordinated decisions;
>
> **Balance**. There is a real paralysis of the supervisory cooperative arrangement due to a significant imbalance in the supervisory relationship between Home and Hosts competent authorities of the market player involved (the major business units are located in Hosts jurisdictions or the trans-European market player represents a very significant percentage of the activity in given Host jurisdictions);
>
> **Integration**. There should be a high degree of integration at EU level of the securities activity (or market segment) involved;
>
> **Uniformity**. Rapid and uniform effect of this supervisory decision throughout the Union is not provided anymore by the mutual recognition system.[10]

CESR emphasised that "so far, there is no[] unanimously voiced supervisory issue that would urgently and immediately require an EU single decision".[11] However, it also noted several contexts where other commentators had mentioned it might be appropriate to employ a single EU decision. These included: the approval at an EU level of EU-wide public offerings of highly standardised products, the approval at an EU level of standardised UCITS (Undertakings for Collective Investments in Transferable Securities), situations when market confidence is at risk, the provision of a single EU permit for credit-rating agencies, and the regulation at an EU level of certain trans-European market infrastructures (such as exchanges, and clearing and settlement providers).

CESR specifically did not recommend the establishment of an ESEC, highlighting that:

> It is not proposed to create new institutions embedded in the Treaty with no precise idea of their role but rather to pragmatically adapt the EU supervisory arrangements to what will occur in the European securities markets.[12]

At the same time, however, CESR also argued that:

> [its] analysis would be incomplete if it would not flag that the need to consider supervisory tools carrying a trans-national dimension is closer than it was four years ago when the Committee of Wise Men, chaired by Baron Lamfalussy, was set up.[13]

CESR's main conclusions in the Himalaya report concerning the future supervisory structure for the EU securities markets may be summarised as follows:

1) The FSAP is based on the mutual recognition approach, and this requires that Member State regulators have equivalent legal powers and use these powers with the same intensity.

2) CESR must implement the existing supervisory tools under the FSAP and the Lamfalussy approach.

3) The mutual recognition approach will be tested by multi-jurisdictional players and other factors. If existing supervisory tools are not sufficient, the EU institutions could grant CESR Members additional supervisory tools, some of which could be put in place rapidly, while others could be activated at a later stage.

4) All possible tools under the present legal framework of the FSAP should be explored before envisaging more far reaching approaches, including trans-national options. These options should be considered only if the present system cannot be developed to provide proper solutions to the questions of supervisory convergence.

5) Consideration of trans-national options is risky as the focus of attention might move too soon away from the immediate priorities.

3. Current Perspectives in the UK

There are different perspectives in the UK towards the creation of an ESEC. This section describes the current public official position, the diversity of City perspectives on EU issues concerning financial markets in general, and finally the perspectives of various groups of UK market participants which support, or at least take positions consistent with, the creation of an ESEC. Some brief comments are made initially on how the term "ESEC" is used here.

A Minimal Definition of an ESEC

Before determining what strategy the UK both has, and should adopt, towards the creation of an ESEC, it is logically necessary to define what such an institution would be and do. No strategy could be decided without knowing what kind of institution is being contemplated.

However, the very act of analysing how an ESEC might be constituted, and what functions it might undertake, presupposes an acceptance of the need for such an institution, or at least support for the possibility that its existence should be considered. And that means that the optimal strategy the UK should adopt has, at least partially, already been predetermined.

Rather than fall foul of this paradox here, a more simple, and expressly political, attitude towards the nature of any putative ESEC is adopted. In particular, two fundamental characteristics of any ESEC are believed critical: first, it should be a body that has some official EU status, and second, it should be able to take decisions concerning the regulation of the EU securities markets autonomously, namely be independent of both Member State regulators and the EU Institutions. These two defining characteristics are the ones of most political concern.

There are many structural models such an ESEC could have. At one extreme, it might be constituted as a small body focusing on a very limited set of activities, and operate in tandem with existing national regulators; at the other extreme it might replace all national regulators. Under the above definition, an ESEC might also undertake any subset of the activities associated with regulatory agencies, including, but not limited to, policy setting, rule-making, supervision, enforcement, conducting investigations, and maintaining a central database about sanctions, trade reporting or corporate disclosures. While it is debatable under the definition employed here whether either the ESC or CESR could reasonably be considered an ESEC, the expectation is that were an ESEC to be created, it would have more powers and more autonomy than either of these two bodies.

Although minimal in the extreme, the above definition does have two important implications about the nature of an ESEC. First, the existence of an institution called a European *Securities and Exchange Commission* does not mean that such an body would simply be a European mirror of *the* SEC, namely the US SEC. As just noted, both the institutional structure of any putative ESEC and any functions it undertook could be completely different from the American version. Second, any putative ESEC would not necessarily be the European equivalent of the UK's Financial Services Authority (FSA), namely an institution charged to regulate not only the securities markets, but also the banking and insurance markets. Any attempt to create an EU FSA will of necessity be significantly harder politically to achieve than simply an ESEC.

The Current Official Position

From the UK's point of view, the Lamfalussy Process is a giant experiment on an issue of critical importance to the UK's economic interests. There is almost universal consensus in the UK that the field of financial services is one of the few areas where what is beneficial for the UK is also unequivocally beneficial for the EU, and vice versa. The City, representing financial markets in the

UK, is stressed as being a European asset that underpins nearly 200,000 jobs across the rest of Europe and brings benefits to the whole of the EU.[14] It is also believed that if the same relatively open and competitive approach that is used in the UK were adopted in the EU, it would be to the great advantage both of the EU, and to UK interests which would likely thrive in such a competitive environment. Given this, the fundamental issue for the UK is can Lamfalussy deliver.

More specifically, can a formal structure in which cost-benefit analyses are required to justify the adoption and implementation of policy, actually succeed in delivering policies that are economically beneficial to the EU. If so, well and good, both for the EU and the UK. And if the Lamfalussy Process is successful in doing this, there is unlikely to be short-term pressure to change the institutional structure under which it operates (although as noted below, the success of the Lamfalussy Process may itself lead to calls for an ESEC).

The current official UK perspective on whether there should be an ESEC is simple: *Against*. As stated succinctly by the Select Committee on the European Union of the House of Lords: "There is no case for a European Regulator for as far forward as we can realistically see".[15] Rather, the UK authorities believe that attention should be focused on delivering the FSAP, and on using the Lamfalussy Process to facilitate its implementation. They identify five priorities to do this:

> **better implementation and enforcement of EU measures affecting the financial sector**. A significant number of the FSAP measures that have been adopted have still to be implemented nationally. That should be a top priority, together with their subsequent enforcement;
>
> **alternatives to EU regulation**. In general, EU legislation should be a last resort, and alternative approaches to policy making, such as more use of EU competition policy, market-based solutions and initiatives at national level, should be considered first;
>
> **better regulation**. In some specific cases, market failure analysis may demonstrate that further new EU legislation in financial services could be necessary. When new EU legislation on financial services is being considered, a proper assessment of the costs and benefits should be undertaken, and financial market participants should be fully consulted;
>
> **making the Lamfalussy arrangements work well**. These new regulatory arrangements are now in place to supervise financial services across the EU. They have been shown to work for securities markets and are being extended to banking and insurance. They need to be further developed; and
>
> **recognising the global nature of financial services**. It is crucially important to remember that financial markets are global. A global perspective is needed when considering the impact of EU financial services regulation on the competitiveness of EU-based firms and financial centres. International action will sometimes be needed to tackle global issues.[16]

The UK authorities believe that the future structure for the regulation of the EU securities markets requires that:

> the **current legal responsibilities** of home and host supervisors should remain as set out in existing Directives;
>
> the framework provided by **existing Directives** should also form the basis for future

EU legislation on the supervision of cross-border institutions (including branches and subsidiaries);

there is scope within the **range of legislative approaches** currently used within the EU to ensure that future legislation concerning financial supervision can take account of the interests of firms, consumers and supervisors in a more integrated Single Market;

the effective supervision of cross-border institutions will rely on choosing the most appropriate forms of **cooperation** between national financial supervisory authorities and making them work in practice. The choice of model of home-host cooperation should be based on key criteria, taking into account the potential systemic impacts of sectors and individual firms; and

most important of all, financial supervisory authorities need to **work more closely together** within the current legislative framework to deliver effective cooperation at the practical level.[17]

Eleven major arguments against the creation of an ESEC appear to be believed by the UK authorities, even if some of them are too politically incorrect to be put forward officially. They are as follows:

1) The benefits of regulatory competition outweigh the costs. Self-evidently, the possibility of regulatory competition would disappear with the creation of a pan-European securities market regulator that replaced Member State regulators. There are, however, other possible regulatory structures with an ESEC in which some form of regulatory competition may still be possible. For example, an ESEC could be created to operate in tandem, and in competition, with national regulators, allowing market participants to choose to be regulated either by their national regulator or by the ESEC.

2) The policy of regulatory competition has been legally sanctioned in the EU as a direct implication of the three linked strategies that have historically been, and continue to be, employed to achieve the single market for financial services. These are the harmonisation between Member States of the essential core standards for the prudential supervision of financial institutions; the mutual recognition, by each Member State, of the competence of the respective national regulatory bodies to insure compliance with these minimum standards; and the assignment to the home-country, in those areas which have been harmonised between Member States, of the control and supervision of financial institutions. Progressively greater use of maximum rather than minimum harmonisation is, however, accepted as undermining the possibility of regulatory competition.

3) The likelihood is that were true regulatory competition allowed in the EU, the UK would be in a good position to take advantage of it. To the extent that this is already possible, the relative attractiveness of the UK appears to be confirmed by the trend of continental European financial market participants to move their headquarters to London.

4) There is concern that a European securities market regulator would not be sufficiently pro-competitive, but rather would be too interventionist and seek to protect national European

industries, mirroring what is perceived to be the current approach of some continental European regulators, at the expense of the City.

5) The undisputed success of the City as one of the centres of national, regional and global capital markets, means that the UK authorities must be following the right policy to promote the development of financial markets. There is thus no need to establish a centralised EU securities regulator given the evidence that what the UK authorities are doing is correct, and the likelihood that no central EU regulator would be able to do as well.

6) If attention is focused on creating a new European institutional structure for the regulation of EU securities markets, it will divert attention away from implementing the Lamfalussy Process, and is thus likely to be self-fulfilling and self-defeating, given that a failure of the Lamfalussy Process is likely to lead to greater calls precisely for an ESEC.

7) There is skepticism about what an ESEC could do, given that there is no body of EU law that it could enforce. Apart from EU Regulations which are directly applicable in national law, the vast majority of the FSAP is composed of Directives. These Directives need to be transposed into national law before they can be implemented, and it is such national law that market participants are required to follow.

8) The diversity of functions and powers among national European regulators makes it difficult to create an ESEC. Until there is harmonisation of regulatory practices amongst national authorities, there is unlikely to be agreement about what an ESEC should do, given that Member States have very different conceptions about what their own national regulators should do.

9) The FSAP is only now nearing completion, and the Lamfalussy Process has only recently been established, and has not even yet been tested for revisions of Directives, or for delivering Levels 3 and 4. It is therefore premature to consider creating a new European regulatory structure, before the lessons from, and any weaknesses of, the existing one have been identified.[18]

10) The large amount of reforms at the EU level, both in the development and adoption of the FSAP and of the Lamfalussy process, and at the Member State regulatory level, have consumed considerable public and private sector resources to achieve. There is now fatigue throughout the EU with the process of regulatory change, and a desire to see a period of stability in legal and institutional structures.

11) There will be intense political difficulty in creating an ESEC. This was evident on a relatively small level when it was decided to extend the Lamfalussy decision-making process to the banking and insurance markets, and to create analogous committees to the ESC and CESR for these sectors. A crucial factor obstructing this development was political agreement amongst Member States about where the relevant committees should be based. It took eighteen months to determine

that the Committee of European Banking Supervisors (CEBS) should be in London, and that the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) should be in Frankfurt. There is a widespread view that it would take a much longer long time to determine where any hypothetical ESEC should be based, let alone all the other necessary political compromises that would be necessary to make possible its creation.

Notwithstanding the stated position of the UK authorities, and all the above eleven arguments, there has been at least one official signal about the potential merits of an ESEC. In his position as Chairman of CESR's financial reporting group, the current Chief Executive of the FSA recently confirmed that enforcement decisions concerning the application of international accounting standards remain the exclusive preserve of EU Member States. However, he also noted that:

> If we end up, in several years, with an awful lot of fluidity of listings and public offerings cross border, you might say that a [pan-European enforcement body] is the logical argument. But it has to be market driven.[19]

Diversity in the City

It is perhaps self-evident, although not always to participants in the financial markets, that the interests of the UK go beyond those merely of the City, important though the City may be for the UK. Unlike most other countries in Europe (with Luxembourg and increasingly Ireland being the exceptions), however, the interests of the financial community in the UK are often believed to be in the interests of the UK as a whole. Even if the viewpoint of the City is taken as a proxy for the UK when considering what is the optimal approach towards issues concerning financial markets in the EU, determining what the viewpoint of the City is generally, and more specifically on the contentious issue of whether there should be an ESEC, is extremely difficult. This difficulty can be seen at all levels: at the individual firm level; at the trade association level, where firms group themselves together voluntarily to pursue common interests; and at the highest level in the search for a single organisation that may speak for the City as a whole, and thus represent the full set of trade associations, as well as a range of other interests.

Consider the decisions undertaken by individual firms. The industry structure of most sectors of activity in the City is similar to many other industries. There tends to be a relatively large group of relatively small firms which undertake a focused set of activities. The interests of these small firms are typically quite similar and easy to identify. However, as in most industries, most of the business in any particular sector is undertaken by a relatively small number of relatively large and powerful firms. It is difficult to determine the individual viewpoint of any of these firms on a particular topic for many reasons, two of which are noted here.

First, these firms typically have multiple relationships with almost all of the major

participants in the financial markets. This is true, for example, of the largest and most powerful financial intermediaries, the major investment banks. Consider the types of relationships such a firm may have with one of the market infrastructure institutions - namely exchanges, central counter-parties (CCPs) and central securities depositories (CSDs). A single investment bank may be simultaneously a user, a lender, an owner, a competitor, and a supplier – and its staff may also sit on the board of relevant institutions. A similar complex of relationships between the major investment banks and other types of institutions is also common. It is thus not surprising that the large firms each have internally conflicting interests on major issues.

A second source of internally conflicting interests arises from the perceived nationality of the firm. Consider, again the major investment banks operating in the City. Almost all of these institutions are headquartered in the USA, and typically thought of, and think of themselves, as being American. However the cultural and national attitudes of these banks are in reality not so easily characterised.[20] When operating in the EU, the banks are well aware of European sensitivities, and the need both not to look too American, and also not to criticise the authorities of the EU countries in which they operate. Their appointment of key European figures into powerful positions, their expert direct lobbying of the EU political institutions, and their sponsorship of a wide range of national EU cultural programs, all attest to this sensibility, and indicate a desire on their part to look as European as they are American. On any particular subject, particularly one as contentious as the creation of an ESEC, the major US firms based in the City may therefore have internally conflicting views. Even if they do not, however, they are unlikely to wish to reveal their preferences publicly for fear of alienating one particular European or indeed American constituency. A similar caution exists in continental European firms based in the City, which may thrive as a result of the growth of the City, but which do not want to alienate their home Member State constituencies and authorities.

The determination of the viewpoint of a trade association on contentious issues is also often difficult. There is a long history in the City of firms with similar interests grouping themselves together into trade associations in order to further their mutual interests. Currently, there are over fifty such associations representing many different types of institutions, products, sectors, functions and markets.[21] Even in an institution such as a trade association, where firms have relatively similar interests, however, it can be hard to find a position that is mutually acceptable to all the institution's members. The most obvious reason for this is that a trade association's members typically operate in the same market competing fiercely with each other, and it is therefore often difficult for them to agree on things.

A second more indirect reason arises from the financing of trade associations. Typically their large members provide much of their finance and are able to devote more resources to their

operation than smaller members. Even if trade associations are run as cooperatives with individual members each formally having identical voting power, the larger members are therefore likely to have a disproportionate influence in their running. The largest members may seek to use the trade associations to represent their views without having to make the arguments themselves.

The identification of a single voice to speak for all the interests operating in the City is extremely difficult. It used to be the Bank of England which represented the City to the UK government. This role of the Bank has, however, diminished with the growth, diversification and internationalisation of firms in the City, and with the establishment of alternative regulatory authorities both inside the UK, most importantly the FSA, and outside the UK, most importantly at the EU level. If there is any single institution that could, and sometime does, now seek to speak for the City, it is the Corporation of London whose role is "to maximise the performance of the City, as the leading international financial and business centre, in serving global needs". The difficulties of the Corporation acting as the voice of the City, particularly in the context of EU issues, are, however, enormous, as may be illustrated by considering what the Corporation of London announced in 1/2004 as a "major new initiative to strengthen relations between the City and EU decision-makers": the opening of a City Office in Brussels.[22]

It was intended that this Office would help shape new thinking in Brussels about the future make-up and direction of the whole market for financial services in the EU, would act as the "eyes and ears" of the international financial marketplace centred on the City, and would help ensure that the City has a strong "voice and influence" within the EU.[23] In specifying the terms of reference for the proposed Brussels Office, however, the committee overseeing its operation (the Advisory Group) noted the following caveats:

> the Office will be required to ensure that the Corporation and relevant trade associations, exchanges and other bodies with an interest in particular issues under discussion are appropriately consulted; unless specifically advised to the contrary by the Corporation and its Advisory Group, the lobbying of the EU institutions on specific sectoral issues would be for the individual trade associations and practitioners not for collective action although the Office will need to monitor these activities. In particular it will not be the job of the Office to produce technical papers on specific regulatory issues but where necessary to bring to the attention of individual trade associations, practitioners, exchanges and other bodies the potential need for such papers.[24]

These caveats reflected the political circumstances within which the Office would have to operate and strongly limited its role before it was even to begin functioning. The political reality was that some of the individual trade associations were worried that the existence of the Office might prejudice their operations in Brussels and limit their ability to operate autonomously. And it was precisely this, namely the ability of the Office to speak for the City as a whole, sometimes at the cost of the interests of individual firms or trade associations, that was one of its primary

justifications. The situation is sometimes summarised as follows: *There is no London view*.

Private Sector Supporters

Notwithstanding the historical British mistrust of things European, there is a small, but growing, number of UK private sector financial market participants who believe that, or at least take positions consistent with the idea that, the existence of a single EU securities regulator might be preferable to the current situation with so many national Member State regulators, even given the supposed advantages of the Lamfalussy Process. These private sector participants come from different market sectors, have different agendas, and although British are frequently allied to, and important components of, different European institutions. At present, they are also for the most part not too willing to argue in public the merits of an ESEC, and do not operate in a coordinated manner. Three groups of private sector market participants with such views are noted here.

The first group consists of those private sector market participants which have become disappointed with their lack of ability to operate on a cross-border basis in the EU, despite being appropriately regulated in their home Member State and thereby obtaining what they thought to be, and what was advertised as, a "European passport" to provide relevant services throughout the EU. One vocal sector of the financial services industry where this has happened is in fund management. The Fédération Européene des Fonds et Sociétés d'Investissements (FEFSI) (now called the European Fund and Asset Management Association [EFAMA]), the European trade association for investment management, noted for example that,

> inconsistencies between national authorities in implementing European Union rules on cross-border sales [are] causing chaos… The first cases of companies being stopped from selling funds in another country are now being reported to FEFSI. The lack of standardization in the way the so-called UCITS III Directive is being implemented across the EU means fund managers are finding they are compliant in their domestic market, but are inadvertently breaching rules in others.[25]

The argument for establishing a single ESEC in this context is simple. Were an investment management firm to obtain appropriate regulatory approval to operate from any putative ESEC, it would presumably not need to seek the permission of any of the various national regulators in order do business in their country, and in turn, they would not be able to frustrate the entry of appropriately regulated foreign providers into their national markets. This would facilitate the development of a pan-European fund management market.

The second group of market participants which have a likely interest in supporting the idea of an ESEC, are those market infrastructure institutions – including exchanges, CCPs and CSDs – which operate on a cross-border basis in Europe. Each of these institutions is subject to regulatory scrutiny from many different European regulators, in some cases more than ten, some of which also have different functional jurisdictions. The typical approach among the various national regulators

supervising such institutions has been to create a regulatory college, and to agree a memorandum of understanding between themselves in terms of oversight, responsibilities and information sharing.

This approach has, however, lead to difficulties. Both the multiplicity of the relevant regulators, and the differences between them, mean that it can be hard for them to understand each other's problems, let alone agree with each other. In some circumstances it has also meant that the allocation of regulatory responsibilities still remains unclear. Relevant market infrastructure institutions sometimes hint at the fact that they need to be constantly educating and marshalling their relevant regulators simply to prevent regulatory gridlock. The establishment of an ESEC would bring the advantages both that the relevant regulatory responsibility and accountability would be clear, and more importantly from the point of view of the large market infrastructure institutions, that they would only have to deal with a single regulatory body, rather than the many bodies to which they are now subject.

The above position has been most clearly stated by the CEO of LCH.Clearnet as follows:

> Our ability to serve customers better and to reduce our overall cost base will much depend on the continued co-operation of regulatory colleagues and their willingness to support the Group operating a fully integrated management and workforce, within clearly defined and well co-ordinated oversight, preferably on a Europe-wide basis…[26]

The pivotal phrase in the above quote is "on a Europe-wide basis". This does not of course necessarily imply support for an ESEC. Other regulatory institutional arrangements could deliver such oversight on a Europe-wide basis, including the establishment of a lead regulator in Europe for all of LCH.Clearnet's activities, or the full application of a mutual recognition approach which would allow LCH.Clearnet's home regulator to play the dominant role in its regulation. Neither possibility is now available in Europe, given the lack of a Directive on Clearing and Settlement which might allow the establishment of an appropriate passport right for CCPs through Europe, and an acceptance that host country regulators should have a relatively minimal role, compared to the home country regulator, in regulating such institutions. Even if a Directive on Clearing and Settlement were agreed, however, market infrastructure institutions might still face problems similar to those identified by the first group, namely the difficulties associated with realising the purported benefits of a European passport, and might still therefore prefer the possibility of being regulated by a single regulatory body.

There is a third group of UK market participants who are concerned about uneven application of EU rules, and in particular about what they believe to be a particularly British characteristic whereby UK authorities follow rules closely, while all around ignore them. One of the trade associations in the City – the Association of Private Client Investment Managers and Stockbrokers (APCIMS) – called on the government, for example, not to implement the FSAP too

rapidly for fear that by doing so it would place UK market participants at a disadvantage compared to participants in some continental European Member States where implementation would be substantially slower. APCIMS warned that the UK had a history of "gold-plating" EU rules to its disadvantage. The expression "gold plating" was used to refer to four scenarios:

> 1. when the UK implements an EU requirement the same way as other European countries but puts in additional rules;
>
> 2. when the UK implements an EU requirement differently to other European countries with the result that there are more extensive requirements placed on UK firms;
>
> 3. when the UK implements an EU requirement which other European countries have ignored (or which they have transposed into their laws but not implemented); or
>
> 4. when all European countries have implemented a Directive but the UK enforces it with a much more extensive penalty regime.[27]

APCIMS was concerned that although the FSAP aimed to give the EU a single market in financial services, different Member States had very different strategies for implementing its rules. The result could be that countries which have a more liberal approach to financial regulation end up at a competitive advantage to those with stricter regulatory regimes. Although APCIMS and other like-minded UK market participants have not supported the creation of an ESEC, their position effectively calls for similar implementation of all EU rules on an EU wide-basis. The establishment of an ESEC which could intervene at Member State level to ensure this, is not a far step away from such a position. This view has been clearly stated, admittedly by a US organisation, as follows:

> We strongly support and urge the Commission to continue its deliberations to establish a common EU securities regulator with oversight responsibilities over all EU markets and the power to enforce EU Directives across all member states. If enforcement is left to the individual national regulatory agencies, oversight reviews run the risk of being influenced by each regulator's unique sense of priorities, local circumstance, and interpretation, unless they are guided by high-level principles which are either supervised by a new EU wide securities regulator or, alternatively, are directly executable and hence subject to the European Court of Justice's authority.[28]

4. Political Factors

The key political factors affecting the creation of an ESEC are examined in this section. Three relevant issues are discussed. First, the key implications of the Himalaya Report, as opposed to the conclusions drawn in the Report, are analysed. Second, the nature of the economic dream associated with the Lamfalussy Process is identified. Finally, the political reality of the Lamfalussy Process is described.

Himalaya Deconstructed

Understanding the Himalaya Report is crucial for any analysis of the future institutional

structure for supervising the EU securities markets, given both its subject matter and CESR's role. However, the precise importance of the Report is dependent both on what are deemed to be its key implications, and on the status that it is believed that the Report should be afforded. These two issues are briefly examined in turn.

Implications

There are four central implications of the Himalaya Report that are believed most important in the context of considering the creation of an ESEC, and their importance lies in what they reveal about the beliefs and approach of CESR. All four implications are quite distinct from the propositions that CESR identified as being its main conclusions. They are as follows:

i) *Mutual recognition does not, and should not, require regulatory competition.* CESR maintained that the mutual recognition approach continued to form the basis for implementing the FSAP, but also stressed that "… the greatest priority of CESR members is to deepen the cooperation arrangement under the FSAP legal framework to enhance better the Home/Host(s) supervisory relationships and to improve the convergence of approaches and decisions within the Network of securities regulators".[29] CESR's focus on such convergence means that the possibility of different national regulators providing different regulatory solutions, the fundamental consequence of regulatory competition, is seen as undesirable.

ii) *The need for identical supervisory practices implies the need for a single regulator.* CESR believes that mutual recognition requires mutual reliance, and in order to achieve mutual reliance, competent authorities across the EU must have equivalent powers to supervise, must apply the same supervisory intensity to the same issues, and must also benefit from equivalent financial and human resources. The sole way in which this could be achieved is to have single regulator across the whole EU. As stated by the Finnish Ministry of Finance in its comments on the Himalaya Report: "the logical conclusion of an effort to achieve fully identical supervisory practices could end only with a call for a single supervisor with a single staff and institutional structure".[30]

iii) *CESR's dual focus on both the present and the future of the Lamfalussy process is inconsistent.* CESR stressed that only if all possible tools under the current legal framework had been fully exploited, and in particular only if it is very clear that the present system cannot be developed to provide proper solutions to the questions of supervisory convergence, should the possibility of providing the Network with additional legal and supervisory tools be explored. It also, however, did just this, namely explore what types of additional legal and supervisory tools might be adopted, and under what circumstances, in a context where everybody agrees it is too early to determine whether the present system can be developed to provide proper solutions to the questions of supervisory convergence.

iv) *All the many possible future models for regulating the EU securities markets CESR identifies require that the same, or more, power, be centralised at an EU level.* In no circumstances does CESR suggest that any regulatory powers, currently granted to itself or indeed the ESC, be delegated to national competent authorities.

Status

The status that should be afforded the Himalaya Report is crucial, as this affects how the Report's conclusions and implications should be assessed. Three different views of the Report offer very different perspectives. CESR itself describes its Report as a "preliminary analytical paper", a "consultative report", and a "preliminary contribution to the debates on the content of the post-FSAP phase".[31] As such, the implication is that the document should be taken to be an initial, neutral and objective analysis of the issues arising from developments in the FSAP and the Lamfalussy Process.

A second view of the Report is to see it as an instance of bureaucratic imperialism. In this light, CESR is taken to be a body looking to further its own interests, primarily its power and reach. Given that CESR is likely to be the kernel of an ESEC, were such an institution to be formed, it is unsurprising under this perspective that all steps recommended by CESR aimed to enhance CESR's powers, and potentially to promote the creation of an ESEC. This perspective does, however, need to be tempered with the observation that if CESR is viewed as a network of national regulators, as it likes to portray itself, then its members would be unlikely to plot to replace themselves with a single EU body.

Yet a third perspective on the report is to see it as a political signal about the likely future institutional structure for the regulation of the EU's securities markets. CESR's members are after all the chairmen of the national regulatory agencies from around the EU, all appointed by their respective governments, and any report from CESR carries their implicit, if not explicit, support. Under this light, the Report's support for further centralisation, and implicitly for an ESEC, may therefore be taken to reflect the consensus view of CESR's members.

The Economic Dream

The creation of the Lamfalussy Process was undeniably a major political success.[32] The Wise Men found a way within the then-existing EU institutional and Treaty arrangements to create a committee structure that was hoped could respond to the problems they identified. There are also some signs that the Lamfalussy Process is working, and certainly when it is evaluated against the problems the Wise Men sought to solve. The EU legislative system has become faster, and there is now a mechanism to update Directives in a more timely manner than before. There is much greater consultation and transparency than before, although more perhaps could be done, and in a more

coordinated manner. Many of the deficiencies regarding regulatory obligations to cooperate have been addressed by the creation of CESR.

Notwithstanding the above successes, however, the Lamfalussy Process may fail to deliver the desired economic benefits, and indeed Hertig and Lee have argued that it will fail to do so.[33] Their key arguments may be summarised as follows. The comitology-oriented institutional reforms that are central to the Lamfalussy Process will neither reduce delays in regulatory implementation, nor improve substantive flexibility and certainty of EU financial services legislation. National protectionism and bureaucratic inertia will not be constrained, legislation will continue to be excessively technical at the expense of speed, EU institutional power struggles will continue as previously, and enforcement of EU law will remain weak. Some Member states will blame the Lamfalussy Process for any regulatory arbitrage they find unpalatable, even though they originally agreed that it should aim at facilitating mutual recognition, and thus, regulatory competition. Finally, European enlargement will make the Lamfalussy Process irrelevant, as regulatory strategies will aim at maximum harmonisation and centralisation, rather than minimum harmonisation and mutual recognition.

Even if these arguments are not believed as convincing as Hertig and Lee would like to hope, they may still be sufficiently persuasive to question the likelihood that the Lamfalussy dream will be achieved. If the Lamfalussy Process does fail, or at least it is believed likely that it will, the unacceptability of sanctioning regulatory competition in the EU will both reduce objections to, and generate political support for, the establishment of an ESEC.

The Political Reality

The political reality concerning the creation of an ESEC is summarised here under four key propositions:

1) The creation of an ESEC will be determined primarily by politics - economic and legal factors are secondary.

2) Regulatory competition is politically unacceptable

3) There is severe fatigue and overload with regulatory and institutional reforms.

4) Political momentum for the creation of an ESEC is growing.

Each of these propositions is examined in turn.

The Primacy of Politics and the Relative Unimportance of Economics and Law

The key question concerning the creation of an ESEC is whether more regulation – a term used to refer broadly to everything that that regulators do – should be centralised at the European

level than is currently the case. Answers to this question in the legal and economics traditions seek to identify the objectives of regulating securities markets, and then to assess the extent to which centralising regulation furthers these objectives or not. Following the International Organisation of Securities Commissions, three essential objectives can be identified: the protection of investors, ensuring that markets are fair, efficient and transparent, and the reduction of systemic risk.[34] The pivotal issues then are: Does competition between national regulators in the EU deliver these objectives, or would they be better served by more centralisation, and in the end the creation of some form of ESEC?

These questions are difficult to answer.[35] Consider one element of the second objective noted above, namely whether it is more efficient that regulation be carried out at a centralised EU level, as opposed to in a decentralised manner in Member States. It is hard both to measure, let alone identify, the relative costs and benefits of the alternatives of regulating centrally or in a decentralised manner. A comparison would need to be made between the relative costs and benefits of operating the current structure versus those arising in any putative alternative optimal structure. These costs and benefits would need to include not only an assessment of the establishment and operation of the necessary institutional structures, but also the costs and benefits faced by all the individual market participants in the different scenarios. The costs of moving from the current institutional structure to whatever arrangements were deemed optimal, would also need to be assessed. Many of these costs and benefits would need to be estimated, as they could only truly be measured after the relevant institutional changes had been made.

Attempting to assess the relative efficiency of different regulatory structures also ignores a crucial and obvious problem in the formation of any function that aims to provide a rule for how to make decisions at the EU level given the preferences of individual Member States. The difficulty is that different Member States have different preferences with regards which costs are important or not. The distribution of the relevant costs and benefits across Europe, as much as any summation of the total costs and benefits, will thus affect what is seen to be the optimal choice.

As noted above, the benefits of the FSAP have proved difficult to measure for the European Commission. Attempting to measure the effects of the Lamfalussy Process would be even harder. This was evident in the work of the Inter-Institutional Monitoring Group (IIMG) which was established to “assess the progress made on implementing the Lamfalussy Process to secure a more effective securities markets regulatory system, and identify any possible emerging bottlenecks in this process”.[36] In interpreting its mandate, the IIMG did not seek to assess whether the effectiveness of the EU securities markets regulatory system had changed as a result of the Lamfalussy Process, which would have required assessing the economic benefits to the EU arising as a result of the Process. Instead, the IIMG applied an analytical approach based around the

objectives of the Lamfalussy Process, and focused on the how the Process had influenced procedural changes. In particular, it sought to answer the following four questions:

> 1. Has the Lamfalussy Process proved capable of speeding up the legislative process regulating securities markets? Is this Process efficient both in terms of use of resources and in terms of flexibility to keep pace with market developments?
>
> 2. Does the Lamfalussy Process make sufficient use of open and consistent consultation processes that are able to produce "reasoned" responses by the Institutions and CESR? Are the consultation processes "representative" , i.e. do they lead to responses covering both the entire spectrum of relevant actors on financial markets, and actors from many Member States of the European Union?
>
> 3. Have bottlenecks or blockages appeared, with particular regard to timetables?
>
> 4. Has implementation lived up to the expectations raised by the new Process? Has the Lamfalussy Process yielded better results than procedures applied before the Process started?[37]

While an assessment of these procedural changes is important in order to assess whether the EU's legislative procedures themselves are working more efficiently following implementation of the Lamfalussy Process, such an assessment can say nothing about whether the changes enhanced the effectiveness of the EU's securities markets regulatory system in delivering key economic objectives.

The key legal criterion that has been developed in the EU context for deciding what should be done at EU level and what should be left for Member States to regulate is that of "subsidiarity".[38] Its main thesis is that "the functions handed over to the Community [should be] those which the Member States, at the various levels of decision-making, can no longer discharge satisfactorily".[39] The principle of subsidiarity is, however, not sufficient for deciding what should be done at EU level and what should be left for Member States to regulate in the securities markets.[40] At least three competing criteria have been derived from the principle to assess whether EU level intervention is warranted: i) the "common interest" test where "the autonomy of decision-making at whatever level of personal and collective life should be limited only to the extent dictated by the common interest"; ii) the "necessity test" which states that "things should not be done at the EU level unless they cannot be done at national level"; and iii) the "attained better" test which argues that things should be done at the EU level where they can be attained better than at the level of Member States. Even these tests would require substantial exegesis to be usefully implementable in the context of creating an ESEC.

Together, the difficulties noted above have a simple, but important, implication: there is no definitive and widely accepted answer from the economic and legal points of view as to whether there should be an ESEC. In the absence of such an answer, and quite independent of any political factors that might influence the decision, it is therefore unsurprising that the grounds on which Member States consider the issue is primarily political. And, as noted below, there are significant

political factors affecting the interests of Member States that do affect the decision.

The Anathema of Regulatory Competition

Even if it were possible to evaluate the merits of regulatory competition unambiguously from the legal and economic perspectives, regulatory competition is simply anathema to many around the EU. There have been a few rare hints that the merits of competition between national regulators may be more persuasive than they have been before. Historically most continental European financial marketplaces have been significantly smaller, and more domestically-focused, than in the UK, and some Member States have sought to protect their marketplaces against international competition. However, key individuals in some Member States have in limited contexts argued against the creation of an ESEC.[41] While this has been mostly to support the workings of CESR, their statements could at least potentially also be seen in favour of regulatory competition. The entry of the new accession Member States into the EU, many of which are generally more in favour of a pro-competitive anti-interventionist stance than the traditional continental European approach, may also enhance support for more competitive and less protectionist policies in regulating securities markets.

Notwithstanding the above comments, however, to most in the EU the notion of regulatory competition is viewed as intrinsically harmful to the rightful authority of important national institutions. As noted above, a key implication of the Himalaya Report is that CESR does not support it. A range of Member States are also unwilling to countenance the possibility of mutual recognition for fear that their national institutions might lose out in an internationally competitive environment, as indeed some are bound to do. There is also concern that competition between regulatory regimes may encourage the adoption of Anglo-American practices and cultures in the securities markets. Such an outcome is objectionable to many Member States in continental Europe.

Regulatory Fatigue and Overload

If there is one thing that is universally agreed around the securities markets in the EU, it is that everybody is overloaded and tired by the vast amount of regulatory initiatives arising both from the FSAP, and from the institutional reforms initiated by the Lamfalussy Process. This fatigue does not mean, however, that everybody is unwilling to countenance any further changes. When significant enough political issues are at stake, as discussed below, people are already exhibiting a will for further change.

Support is Growing

Even if it is not accepted that an ESEC is inevitable, as argued by Hertig and Lee, it is maintained here that support for the creation of an ESEC is growing, and likely to grow faster. Two

types of evidence are put forward to confirm this contention. The first is the support that has already been publicly declared to date in favour of an ESEC, or that is at least consistent with the creation of such an institution. The second is a range of political factors that make support for an ESEC more likely.

A variety of institutions and people have indicated their support for an ESEC, or at least taken positions consistent with the creation of such an institution. Although not explicitly advocating an ESEC, CESR's backing for the need for identical supervisory practices implies its support for a single EU regulator, and this also is consistent with all of its proposed future models for regulating the EU securities markets, which require that the same or more power be centralised at an EU level. Views among market participants are hard to assess. As noted above, there are some supporters of the concept in the UK. A very informal gauge of other market support may be obtained by considering the responses submitted to CESR subsequent to its publication of the Himalaya Report. Of the twenty-six responses (of which at least two were from official institutions), perhaps eight were in favour of, or at least supported the need to examine the need for, a single EU regulatory body, whether it be in the near- or long-term, and fifteen were against it.[42] While some Member States have explicitly rejected the need for a single EU regulator,[43] others support the idea.[44] At the European Parliament, the current Chair of the Economics and Monetary Affairs Committee has openly called for the creation of a pan-European securities market regulator, with a statement that reflects a commonly held view around Europe: "You can't have a single market without a lead regulator overseeing it".[45]

There are four key factors that are likely to enhance support for the creation of an ESEC, even disregarding the possibility that a failure of the Lamfalussy Process is likely to lead to calls for its creation. The first two are relatively simple. First, as firms in the financial markets across the EU become progressively more integrated, they are likely to believe an ESEC to be more advantageous to themselves than the current fragmented regulatory environment. Second, the unacceptability of regulatory competition provides a strong incentive for continued and progressively more regulatory centralisation – and the creation of an ESEC is a logical conclusion to this trend.

The third factor that is likely to enhance support for the creation of an ESEC relates to Member States' perceptions about the role of the UK in the EU. There is a paradox at the heart of different Member States' viewpoints about the development of financial services in the EU. On the one hand, as noted above, there is almost universal consensus in the UK that the field of financial services is one of the few areas where what is beneficial for the UK is also unequivocally beneficial for the EU, and visa versa. On the other hand, the very fact that developments in financial services are likely to be beneficial for the UK means that some other Member States in the EU are wary of supporting them, despite being aware of the economic benefits the EU as a whole, and indeed they

themselves, could obtain by their doing so.

In part, this is a continuation of the protectionism these Member States have historically practiced in order to defend their domestic financial services industries against the competitive threat from the UK. More importantly, however, it is based on a political calculation, and one indeed that has been implicitly supported by the significant political emphasis the Council of Ministers has placed on the development of financial markets following the Stockholm Summit and the initiation of the Lamfalussy Process, which is that developments in EU financial services are likely to bring political power to the UK. This argument arises irrespective of whether Member States believe their domestic financial markets will flourish or not. Enhancing the power of the UK in the EU is not seen as politically attractive. One way of curbing this power would be to establish an ESEC.

Paradoxically, it is likely to be the effect of the recent votes on the European Constitution that will be the most important, and fourth, factor in changing the political climate in the EU significantly in favour of creating an ESEC. The 'No' votes in both France and the Netherlands reflected a range of concerns, two of which are most important in this context. These were that the Constitution would move the EU in an 'Anglo-Saxon' direction economically, and that the power of 'Brussels', meaning the EU Institutions and other EU agencies, was excessive and unaccountable.[46]

At first sight, the creation of an ESEC might be thought to exacerbate both of these concerns, and therefore be unattractive politically. Not only would the establishment of such an institution clearly put the role of the capital markets at the centre stage of European political activity, it would also unambiguously hand more power to *Brussels* in the form of a new EU institution. In the immediate aftermath of the French and Dutch votes, there has certainly been great concern amongst the European Institutions that the No votes will stymie further European financial reforms.[47]

However, Member States in favour of more European political integration may in fact see an opportunity in the creation of an ESEC to persuade their electorates that the European *vision*, in the broadest sense of the term, is not only not dead, but also necessary to respond to their concerns. Far from enhancing the role of the capital markets, Member States could argue that the creation of a powerful European securities market regulator is required precisely to constrain the perceived undesirable power of the global capital markets. With an appropriate governance structure and accountability, such an institution could also be heralded as being an example of a more democratic EU. At a time when the political elite of Europe has been shown to have ignored, and been disengaged from, populist concerns, the creation of an ESEC would satisfy both the European elite's view that the only option for Europe is to integrate further by creating new and powerful European institutions, and populist hopes that the unacceptably intrusive nature of global capitalism

be constrained by an appropriately democratic European institution.

If such a strategy appears far-fetched in current circumstances, it may appear less so when considered in the context of various public responses to the No Votes. For example, the following exhortation appeared in one UK newspaper subsequent to the French and Dutch referenda:

> If Europe has a mission, it must be to … reassert[]its core belief in the primacy of politics over markets and devis[e] structures strong enough to make it stick. This may seem like a remote prospect in today's political climate, but the crisis over the constitution could yet produce some unexpected responses.[48]

> More relevantly in the context of the creation of an ESEC, it was suggested that:

> One way or another, Europe's crisis can only be resolved if it is prepared to match economic integration with political structures that bring markets back into balance with society.[49]

Two different scenarios for the establishment of an ESEC are most likely. The first is that a sufficient number of Member States seek to create such an institution for the whole EU, and that they, together with the other EU Institutions, make the future benefits to Member States which the FSAP is intended to deliver conditional upon Member States accepting the jurisdiction of the newly created ESEC over their respective domestic markets. For those Member States which wish to constrain the power of the UK in the financial markets, this is of course the most desirable option. An attempt to pursue this policy may, however, fail if either there is insufficient political support for it around the EU, or if a robust legal argument can be made against it by any particular Member State which wishes to continue obtaining the benefits of the FSAP, but at the same time believes it is under no obligation to submit to the jurisdiction of any newly created ESEC.

If this occurs, a second scenario for the creation of an ESEC, and one that has been widely signalled, is most likely. In particular, an "inner core" of EU countries may seek to push forward with ever greater integration, as indeed French Ministers are reportedly already seeking to do.[50] Under this scenario, acceptance of the jurisdiction of an ESEC would be optional to Member States. Even if its jurisdiction were to be accepted on a voluntary basis, the creation of an ESEC is likely to have several benefits to those Member States which did choose to accept its power. As noted above, it would still allow them to portray the EU and its institutions as a means of responding to populist concerns. It would also put political pressure on those Member States which chose not to participate in the project.

5. Optimal UK Strategy

The optimal strategy the UK should adopt towards the creation of an ESEC, given the prior analysis, is discussed in this section. In order to do this, three broad strategies are firstly identified and assessed. They are:

1) Support the Lamfalussy Process, and reject the creation of an ESEC ("*Current Official UK*").

2) Reject the Lamfalussy Process and reject the FSAP ("*The Strangelove Alternative"*).

3) Support the Lamfalussy Process and the creation of an ESEC ("*Negotiate when Necessary"*).

An optimal strategy combining elements of each of these three strategies, and designated a path of "*Constructive Inconsistency*", is then proposed.

Current Official UK

Given the economic value of the Lamfalussy Process to the UK if it succeeds, official UK support for the Process is therefore clearly and unsurprisingly in the UK's best interests. As any focus on creating an ESEC at present may undermine the delivery of the Lamfalussy Process, rejection of the need for an ESEC at present is also apparently logical. This *Current Official UK* strategy will, however, only continue to serve the interests of the UK until either it is perceived in the UK that the Lamfalussy Process is not working, or until the political reality bites, namely when the calls for the creation of an ESEC throughout the EU become so insistent that they cannot be ignored. At that stage, the strategy will not be sufficient. To reiterate support for the Lamfalussy Process will not ensure that it continues. To reject the possible creation of an ESEC in the face of growing calls for the existence of one, will not stop its establishment.

The Strangelove Alternative

The Strangelove Alternative requires the UK to reject the Lamfalussy Process, and indeed the FSAP, and thereby disengage from EU financial regulation. This position has been most clearly advocated by Lascelles, as follows:

> … because of the City's importance, it is in the UK's interests to press for early reforms to the FSAP. But since these are unlikely to be conceded, the UK should also explore the implications of opting out of the FSAP altogether and repatriating control of financial regulation. Although there would be a political cost, this would liberate the City from the FSAP straitjacket and greatly strengthen it[s] long term prospects.[51]

It is possible that withdrawal from the FSAP and the Lamfalussy Process might be the best policy for the UK. It may indeed also be optimal for the EU, if the UK's capital markets were to become significantly more efficient than they are under the current EU regulatory regime, and if EU market participants were not restricted from accessing the UK's markets in such circumstances. *The Strangelove Alternative* must, however, be rejected for now for several reasons.

Just as there is little solid evidence to confirm that the FSAP and Lamfalussy Process are delivering their intended goals, there is also little solid evidence that the contrary is true, namely that they are harming the development of the UK's and the EU's securities markets. As noted

above, there is clearly fatigue throughout the EU with the vast amount of regulatory and institutional reforms arising from the FSAP and the Lamfalussy Process, and a large amount of resources have been expended by both public and private sector market participants in facilitating its creation. There are also many UK market participants who are disenchanted with both specific Directives and with what is perceived to be a general fault with the EU approach, namely that it is insufficiently pro-competitive. Even together, however, these do not appear sufficient to make a robust case that the Lamfalussy Process is currently harming UK interests. Furthermore the consequences of pursuing *the Strangelove Alternative* are both unpredictable, and potentially extremely adverse, including most obviously the possible exclusion of UK market participants from the EU's Single Market.[52] The high likelihood of there being significantly adverse consequences makes such a policy too risky at present. And like all nuclear options, it can always be pursued at a later date if sufficiently solid evidence becomes available.

It is on this point, however, namely on what would constitute *sufficiently solid evidence*, that UK policy needs to be clear. On the one hand, to require what is typically thought of as sufficiently solid evidence to determine that the FSAP and the Lamfalussy Process are harming UK interests, may be too demanding a criterion, in that by the time relevant proof is available, the UK financial markets may have suffered irreversible damage. If the FSAP and the Lamfalussy Process encourage elements of the UK (and indeed EU) financial markets to move elsewhere, it will be very difficult to attract them back again, as the perennial example of the Eurobond market makes clear. On the other hand, to make a judgment that the FSAP and the Lamfalussy Process are harming UK (and again EU) interests based essentially on political factors, namely on the strength of opinion in the UK or in the City against the FSAP and the Lamfalussy Process, will not lead to a good public policy choice. There may be many factors affecting such a body of opinion other than simply the merits of the FSAP and the Lamfalussy Process.

While it is vital that the UK government determine the criteria for deciding when the Lamfalussy Process and FSAP are harming UK interests, it may be wise not to make them public too early, and in particular not until a judgment has been reached that UK interests are in fact being harmed. To do otherwise is likely both to antagonise other Member States, and to provide a rallying call for the many political constituencies that wish to attack the institutions of the EU quite generally, rather than assess the FSAP and Lamfalussy Process on their merits.

Negotiate when Necessary

If calls for an ESEC do become so loud they cannot be ignored, it is still possible for the UK to do just that, namely ignore the calls and reject the notion of an ESEC. However, this is likely to be an unproductive strategy, as it will push the UK into its standard weak situation in the EU. Stereotypically, the UK says no to a key European venture, and finds itself isolated, thereby

ensuring that it has only a marginal say in how the venture is constructed. Then when the relevant venture has been initiated, the UK discovers that the only choices it has are either to opt-out, or to enter into something which is not the best deal it could have negotiated had it participated in the process of creation.

In such circumstances, the UK should therefore be ready to adopt a *Negotiate when Necessary* strategy, in which it seeks to promote the attributes that it believes an ESEC should have. Self-evidently the precise nature of the calls for an ESEC will affect the appropriate UK response strategy – with different strategies being appropriate to respond to calls for an EU-wide ESEC or for an "inner-core" ESEC. Entering into the *Negotiate when Necessary* strategy does not, however, mean that the UK will be obliged to accept the outcome of such negotiations. In the last resort, *the Strangelove Alternative* can always be adopted. Not to negotiate, however, is simply to give up a bargaining option that could be beneficial for UK interests.

One of the most important attributes of an ESEC that the UK should seek to promote is that the ESEC should only undertake any functions where it is more efficient for it to do so, rather than let them continue to be undertaken at the national level. Given the anathema of regulatory competition discussed above, however, it is improbable that this would be widely acceptable throughout the EU. Paradoxically, therefore, if the UK is forced into adopting a *Negotiate when Necessary* strategy, the end-result of *the Strangelove Alternative* may become more likely.

Constructive Inconsistency

It is recommended here that the UK adopt a three-pronged strategy towards the creation of an ESEC, designated a path of *Constructive Inconsistency*. The three prongs are as follows:

1) *Hope for the Best* – Support the FSAP/Lamfalussy Process and reject an ESEC.

2) *Prepare for the Worst* – Understand when to Reject the Lamfalussy Process and the FSAP.

3) *Compromise if Viable* – Support the FSAP/Lamfalussy Process and a well-structured ESEC.

Two characteristics of this strategy are important. First, it is inconsistent – both rejecting the possibility of an ESEC until the need for such an institution is proven, and at the same time debating how such an institution should be structured, before its existence has been shown to be necessary. Such inconsistency is not, however, thought a problem. On the contrary, given that political considerations will prevail over economic and legal factors in determining the best way of supervising the EU's securities markets, and that other key participants' policies, and in particular that of CESR, towards the creation of an ESEC are themselves inconsistent, the strategy is believed not only constructive, but indeed rational.

The second important characteristic of the three-pronged strategy is that it is not

revolutionary, radical or even reformist in approach. The fundamental differences between it and the *Current Official UK* strategy are that it makes explicit the need to justify the UK's continued participation in the FSAP and the Lamfalussy Process, rather than simply taking this for granted, and that it forces consideration of when an exit from such participation becomes necessary. UK support for an ESEC would be dependent on it being appropriately structured.

6. Conclusions

This paper analyses the factors influencing whether a European Securities and Exchange Commission (ESEC) will be created and confirms the primary role that politics will play in its establishment. In the face of growing support for an ESEC, the paper recommends a strategy the UK should adopt towards the creation of such an institution. It is proposed that the UK adopt a three-pronged approach. First, the UK must, as it currently does, support the Lamfalussy Process in the hope that it works. Second, the UK must determine what criteria need to be assessed in order to evaluate whether the Lamfalussy Process together with the Financial Services Action Plan are in fact harming UK interests, and then make such an evaluation. Finally, if political support for an ESEC becomes unstoppable, the UK should negotiate for the creation of an appropriately structured ESEC – even though its backing for the Lamfalussy Process should logically preclude its support for any type of ESEC. A key attribute of the recommended strategy is thus that it is inconsistent. This is not, however, thought a problem. On the contrary, given that the creation of an ESEC is the stuff of politics and thus that a political response is called for, and given that other key participants' policies on the creation of an ESEC are themselves inconsistent, the strategy proposed here is argued as being not only constructive, but indeed rational.

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Notes

[1] See Committee of Wise Men (2000) and (2001).

[2] See Lenaerts & Verhoeven (2000).

[3] p. 12, CESR (10/2004).

[4] See European Commission (1999).

[5] These comments, and the subsequent quote are taken from European Commission, DG Internal Market Services (7/5/2004).

[6] CESR (10/2004). See Hertig & Lee (10/2003) and references therein for previous discussions about the issue. For other analyses, see Billot (4/2005), EFR (6/2004), European Commission (4/2005), FESE (Kremer) (1/2001) and FESE (Lefebvre) (11/2004).

[7] p. 4, CESR (10/2004).

[8] See CESR (4/2004).

[9] p. 16, CESR (10/2004).

[10] ibid.

[11] p. 17, ibid.

[12] p. 2, ibid.

[13] p. 23, ibid.

[14] See, for example, CEBR (1/2004) and London Economics (11/2002).

[15] House of Lords, Select Committee on the European Union (18/11/2003). The Select Committee is not part of the Government. See also European Commission (6/2002) and Davies (6/3/2003) & (3/2/2004).

[16] pp. 12-13, HMT, FSA & Bank of England (5/2004).

[17] p. 35, HMT, FSA & Bank of England (1/2005).

[18] See, for example, Tiner (22/6/2004).

[19] Parker (9/8/2004).

[20] See Lee (2002).

[21] Lascelles & Boleat (15/11/2002).

[22] Corporation of London (19/1/2004).

[23] The formal objectives of the Office were specified in Corporation of London (undated 2004).

[24] ibid.

[25] Davis (2/8/2004). The UCITS III Directive is intended to provide a passport for providers of relevant funds to offer these funds throughout the EU.

[26] LCH.Clearnet (2004).

[27] APCIMS (5/2004).

[28] See European Advocacy Committee, AIMR (31/3/2001).

[29] pp. 2-3, CESR (10/2004).

[30] p. 1, Ministry of Finance, Finland (1/31/2005).

[31] p. 3, CESR (10/2004).

[32] This and the next paragraph draw on Hertig & Lee (10/2003).

[33] As cited above.

[34] IOSCO (2/2002).

[35] The merits of regulatory competition have been investigated in various contexts. See, for example, Choi (2003), Jackson (7/2001), Jackson & Pan (2/2001), Ribstein (2005), Romano (30/6/2001) and Wymeersch (9/6/2004).

[36] p. 16, IIMG (5/2003).

[37] p. 18, IIMG (5/2003).

[38] This argument, and paragraph, draws on Lee (1996). A further important criterion is that of "proportionality" - see, for example, p. 6, European Commission (5/2005).

[39] p. 1, European Commission (27/10/1992).

[40] See, for example, p. 13, Adonis and Jones (4/1991).

[41] See, for example, some of the comments by the Chairman of the Belgian Regulator (CBFA), in Wymeersch (9/6/2004), and by the Chairman of the Italian Regulator (CONSOB), in Spaventa (20/3/2003).

[42] See submissions from AFEP, BDB, Deutsche Bank, Deutsche Börse, FBE, FFSA, Fortis Bank, and HVB, all of which are available on CESR's website - http://www.cesr-eu.org/.

[43] For example, Finland, Sweden and the UK. See Ministry of Finance, Finland (1/31/2005) and Ministry of Finance, Sweden (Regeringskansliet) (1/31/2005).

[44] In particular, France. See Norman & Crook (11/7/2000).

[45] See AFX UK Focus (2005-02-08 01:56 GMT) & Wright (30/5/2005).

[46] See Hughes (29/5/2005 21:13 GMT) and BBC News (1/6/2005 23:15 GMT).

[47] See, for example, Blum (13/6/2005).

[48] Clark (8/6/2005).

[49] ibid.

[50] Browne (14/6/2005).

[51] p. 2, Lascelles (12/2004).

[52] This is so, notwithstanding Lascelles' argument that relevant wholesale market participants already have sufficient legal standing in other Member States so that their not being able to use a UK-based regulatory financial "passport" will not be too costly.