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Niamh Moloney

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The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (2) Rules in Action

Niamh Moloney*

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Abstract
*The purpose of this article, and of its earlier companion article,** is to examine the implications of the new European Securities and Markets Authority which was established in January 2011.*

In the wake of the financial crisis, the case for institutional reform and for conferring regulatory and supervisory powers on a central EU authority became compelling. But any institutional design would have struggled given the necessity for compromise. The central difficulty is one of nuance. Where on the spectrum from national powers to EU powers, and with respect to regulation and supervision, should any new body's powers be placed if optimum outcomes are to be achieved? The question is further complicated by the different dynamics and risks of centralising rule-making and of centralising supervision, even if there is considerable symbiosis between these activities.

This article considers ESMA's supervisory powers. It argues that, by contrast with its rule-making powers, the current and potential extent of ESMA's supervisory powers has pushed ESMA too high up the spectrum towards EU intervention. Local supervision of the EU rule-book represents an important safety valve for the EU financial market but this safety valve may be obstructed by ESMA's undue standardisation of supervisory practices. ESMA's extensive direct supervisory powers are also troubling given concerns as to their effectiveness. It was always going to be a challenge to draw the dividing line between ESMA's supervisory powers and those of national competent authorities. But the line may have been drawn too far on the side of operational centralisation.

Keywords: financial crisis, EU, EU financial markets, European Securities and Markets Authority, ESMA, regulation of financial markets, supervision of financial markets.

1. ESMA AND SUPERVISION

1.1 Introduction

The January 2011 establishment of the European Securities and Markets Authority (ESMA)[1] was an epochal moment for EU financial market regulation. ESMA,

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** N. Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (1) Rule-making', 12 *European Business Organization Law Review* (2011) p. 41 (Part 1).

1 Regulation (EU) No 1095/2010, *OJ* 2010 L 331/84. The 2010 Omnibus Directive sets out the first set of delegations to ESMA under pre-existing EU rules: Directive 2010/78/EU, *OJ* 2010 L 331/120. It is to be implemented by 31 December 2011. ESMA's first official publication took the form of an FAQ document: ESMA, *Frequently Asked Questions. A Guide to Understanding ESMA* (2011).

together with the two other European Supervisory Authorities or 'ESAs' (the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA)),[2] the European Systemic Risk Board (the ESRB, which has overall responsibility for monitoring systemic risk[3]) and Member State competent authorities, forms part of the new European System of Financial Supervision (ESFS). The ESAs replace the networked-based and unstable '3L3' committees (CESR (in the securities field), CEBS (in the banking field) and CEIOPS (insurance and occupational pensions)) which previously advised the Commission on delegated rules and engaged in a range of supervisory coordination and convergence activities.

The purpose of this article is to examine ESMA's likely impact on 'rules in action' or on the supervision of EU financial markets. The notion of rule-making, canvassed in Part 1, is relatively intuitive. But an initial definitional issue arises with respect to supervision. The border line between rules and supervisory practices is blurring as rules become more focused on outcomes and as operational supervisory practices are shaped by process-based rules.[4] But as suggested in Part 1, the distinction remains valid and useful in the EU context. So what is supervision?[5] The 2009 de Larosière Report suggests that

> the prime objective of supervision is to ensure that the rules applicable to the financial sector are adequately implemented, in order to preserve financial stability and thereby to ensure confidence in the financial system as a whole and sufficient protection for the customers of financial services.[6]

But the 'adequate implementation' of financial market rules presupposes that optimal decisions are made with respect to a host of determinative factors. These include: the particular outcomes which rules should pursue and the style of rules (whether rule or

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On ESMA, see further E. Ferran, 'Understanding the Shape of the New Institutional Architecture of EU Financial Market Supervision' (2010), available at: <http://ssrn.com/abstract=1701147>, and E. Wymeersch, 'The Reforms of the European Financial Supervisory System – An Overview', 7 *European Company and Financial Law Review* (2010) p. 240.

2 Respectively, Regulation (EU) No 1093/2010, *OJ* 2010 L 331/12 and Regulation (EU) No 1094/2010, *OJ* 2010 L 331/48. This article focuses on the securities markets.

3 Regulation (EU) No 1090/2010, *OJ* 2010 L 331/1. See further K. Alexander and E. Ferran, 'Can Soft Law Bodies Be Effective: The Special Case of the European Systemic Risk Board', 35 *European Law Review* (2010) p. 751, and F. Recine and P.G. Teixeira, 'The New Financial Stability Architecture in the EU' (2009), available at: <http://ssrn.com/abstract=1509304>.

4 E.g., the emerging concern with product governance rules, noted *infra*.

5 This discussion is concerned with *ex ante* supervision rather than with *ex post* enforcement, in part as enforcement is also a function of private action and is not the exclusive domain of the supervisor. But the balance between *ex ante* supervision and *ex post* enforcement has significant implications for the achievement of good supervisory outcomes.

6 The High-Level Group on Financial Supervision in the EU, *Report* (2009) (the DLG Report), at pp. 38-39.

principles-based, process or standard-based, for example[7]); the institutional structure of supervision; the supervisor's organisational incentives and internal structures; the supervisory style adopted (whether supervision is risk-based, for example[8]); the intensity of supervision (including the extent to which internal firm processes are relied on by the supervisor, or whether the supervisor second-guesses and/or models the impact of firm practices); the quality of the information sources available to the supervisor; and the allocation of resources.[9] Market features (including the dominance or otherwise of retail investors) and political factors also determine the nature of supervision and the outcomes it achieves. This complexity is reflected in the IMF/World Bank Financial Sector Assessment Programme's characterisation of supervision in terms of the authority and tools of the supervisor to monitor and verify compliance and to remedy, enforce, take control and restructure;[10] this approach associates supervision with the supervisor's overall 'capacity to act'.[11]

The notion of supervision is further stratified in the EU. First, and traditionally, it is concerned with the coordination and organisation of supervision across the internal financial market, whether through, for example, the allocation of home/host supervisory jurisdiction, cooperation and information-sharing obligations, delegation structures, voluntary cooperation and coordination devices, colleges of supervisors, cross-border resolution and rescue mechanisms, or, ultimately, through the allocation of supervision to a central authority. The coordination element has long been a feature of EU intervention. The second element, which, for the most part, is new to the EU, concerns the operational business of supervision and how the achievement of particular outcomes by Member State supervisors and/or pan-EU coordinating structures can be supported. Here, the spectrum of potential EU intervention ranges from soft guidance on how supervision should be carried out, to EU intervention concerning the different elements which shape supervisory decision-making and, ultimately, to the transfer of operational supervisory control to a central authority.

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[7] For an early discussion of rule design and its impact on outcomes, see J. Black, 'Which Arrow? Rule Types and Regulatory Policy', *Public Law* (1995) p. 94.

[8] E.g., J. Black, 'The Emergence of Risk-based Regulation and the New Public Risk Management in the UK', *Public Law* (2005) p. 512, and *idem*, 'Risk Based Regulation: Choices, Practices and Lessons Being Learned', in *Risk and Regulatory Policy: Improving the Governance of Risk* (OECD, Paris 2010).

[9] E.g. H. Jackson, 'An American Perspective on the UK FSA, Politics, Goals, and Regulatory Intensity' (2005), available at: <http//:ssrn.com/abstractid=839284>, *idem*, 'Variations in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications', 24 *Yale Journal on Regulation* (2007) p. 253, and H. Jackson and M. Roe, 'Public and Private Enforcement of Securities Laws: Resource-Based Evidence', 93 *Journal of Financial Economics* (2009) p. 207. In the EU context, see E. Wymeersch, 'The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors', 8 *European Business Organization Law Review* (2007) p. 237.

[10] IMF, *Financial Sector Assessment Programmes Handbook* (2005), at p. 102.

[11] J. Black, 'Enrolling Actors in Regulatory Processes: Examples from UK Financial Services Regulation', *Public Law* (2003) p. 62.

The operational aspect of EU supervision is very closely related to coordination in that effective coordination presupposes confidence by host supervisors in the quality of home supervision, as CESR had long argued in its pre-crisis series of supervisory convergence reports.[12]

Both forms of supervisory engagement are complex. Well-canvassed difficulties arise in the cross-border supervision of financial market actors, the management of cross-border risk transmission, and the construction of effective coordination systems, as the financial crisis has made clear.[13] The questions which operational supervision and the achievement of outcomes raise are challenging, as discussed below. The difficulties are all the greater in the EU context.

1.2 The sharpened focus on achieving outcomes through supervision

While the EU now controls the financial market rule-book, supervision (and enforcement) of rules has long been a Member State competence. Since the outset, efforts have been made to ensure some degree of supervisory coordination and to allocate supervisory jurisdiction.[14] But practical convergence on operational supervisory practices has been given little attention. The last great reform period, the Financial Services Action Plan (FSAP)/Lamfalussy era, was characterised by a concern to enhance law-making and to streamline the cumbersome Treaty-based procedures for legislating. Supervision was a concern of the Lamfalussy process through 'level 3,' which addressed coordination and practical supervisory convergence. But despite CESR's initial efforts in this direction, including the important 2004 Himalaya Report which considered the supervisory 'tool box' that CESR would use to promote coordination,[15] it would not be until the 2007 Lamfalussy Review[16] that serious attention was given to supervision. The Review was not, however, ambitious and followed the soft 'supervisory convergence' model which CESR had promoted. Peer review, mediation, support of delegation, best practice sharing, institutional support of cross-border cooperation concerning market abuse (through CESR-Pol) and the enforcement of financial reporting (through CESR-Fin) were all features of this

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[12] E.g., CESR, *First Progress Report on Supervisory Convergence in the Field of Securities Markets for the Financial Services Committee* (2005) (CESR/05-202) and CESR, *2006 Report on Supervisory Convergence in the Field of Securities Markets* (2006) (CESR/06-259b).

[13] From the large financial crisis scholarship, see, on specific coordination mechanisms, D. Alford, 'Supervisory Colleges: The Global Financial Crisis and Improving International Supervisory Coordination' (2010), available at: <http://ssrn.com/abstract=1545291>, and, on the underlying problems including divergences in national policy preferences, C. Brummer, 'How International Financial Law Works (and How It Doesn't)', 99 *Georgetown Law Journal* (2011) p. 257.

[14] N. Moloney, *EC Securities Regulation*, 2nd edn. (Oxford, OUP 2008), at pp. 1102-1107.

[15] CESR, *Preliminary Progress Report. Which Supervisory Tools for the EU Securities Market? An Analytical Paper by CESR* (2004) (CESR 04-333f) (Himalaya Report).

[16] E.g., European Commission, *Review of the Lamfalussy Process. Strengthening Supervisory Convergence* (2007) (COM(2007) 727).

voluntary model. Immediately prior to the financial crisis, the EU's supervisory agenda was therefore framed in terms of better coordination and a gradual hardening of the soft powers of the 3L3 committee network.[17]

The network model which characterised international supervisory coordination struggled over the financial crisis.[18] It came under much greater strain at EU level where, although it was institutionally and legally significantly more sophisticated, it was subject to intense pressure from the banking crisis and from poor coordination of pan-EU banking group supervision. While severe weaknesses were revealed in the EU's rule-book, the fiscal risks to Member States from poor supervisory coordination and operational management of cross-border risk transmission in an integrated market were laid bare.[19] The importance of effective operational supervision, on a micro level as well as with respect to overall systemic risk and macro-prudential supervision, was a recurring theme in the seminal February 2009 DLG Report.[20] It highlighted the lack of adequate macro-prudential supervision, ineffective early warning systems and the inability of supervisors to take common decisions. But, and of more direct relevance for financial market supervision, it also noted more micro-operational failures, including problems of competence, failures to challenge supervisory practices and a lack of consistent supervisory powers. Similar themes emerged in the Commission's Communication on Driving European Recovery,[21] the June 2009 European Council endorsement of the establishment of a new system of financial supervision[22] and the European Parliament's 2008 call for supervision to be strengthened.[23] More recently, CESR's 2010 'mapping exercise' on emergency powers revealed considerable differences between the powers exercisable by competent authorities in different Member States.[24]

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[17] Moloney, *supra* n. 14, at pp. 1152-1167.

[18] Particularly in terms of the inability of IOSCO and the Basel Committee to respond to the crisis: D. Zaring, 'International Institutional Performance in Crisis', 10 *University of Chicago Journal of International Law* (2010) p. 475, and P.H. Verdier, 'International Regulatory Networks and Their Limits', 34 *Yale Journal of International Law* (2009) p. 113.

[19] See, e.g., N. Moloney, 'EU Financial Market Regulation after the Financial Crisis: "More Europe" or More Risks?', 47 *Common Market Law Review* (2010) p. 1317, W. Fonteyne, et al., 'Crisis Management and Resolution for a European Banking System', IMF Working Paper WP/10/10 (2010), available at: <http://www.imf.org/external/pubs/ft/wp/2010/wp1070>, M. Dabrowski, 'The Global Financial Crisis: Lessons for European Integration' (2009), available at: <http://ssrn.com/abstract=1436432>, and S. Cotterli and E. Gualandri, 'Financial Crisis and Supervision of Cross-Border Groups in the EU' (2009), available at: <http://ssrn.com/abstract=1507750>.

[20] *Supra* n. 6.

[21] COM(2009) 114.

[22] Brussels European Council Conclusions, 18-19 June 2009.

[23] *OJ* 2010 C E 9/48.

[24] ESMA/2011/26, reporting that it was unlikely that national competent authorities could address a crisis situation on a common or comparable legal basis and accordingly act in a fully coordinated manner.

Leaving the institutional reforms to one side, the banking area is leading the EU's reform agenda on supervision, particularly with respect to operational crisis resolution[25] and the formalisation of the roles of colleges of supervisors and of host states of 'significant branches' under the Capital Requirements Directive II (CRD II).[26] But the financial market reform programme is, however, also signalling a much closer focus on supervisory coordination and on operational supervision. More sophisticated mechanisms have been developed to support cross-border coordination under the 2009 UCITS IV Directive, for example.[27] A new generation of EU rules which sit much closer than previously to the difficult boundary where rules and supervision interact is emerging and is likely to have 'spill-over' effects for supervision. This is particularly the case with respect to product regulation. Traditionally eschewed by regulators as generating, *inter alia*, obsolescence, innovation and moral hazard risks, product regulation is experiencing something of a renaissance in the EU. In early 2011, for example, the UK FSA produced a major assessment of the role of retail product regulation which calls for a much more prescriptive approach to product design and for a closer supervisory focus on how products are designed.[28] While considerably less radical, the MiFID Review[29] has suggested that the organisational and risk management requirements which apply to MiFID-scope product providers be enhanced and extended to capture the particular risks raised by product design.[30] While novel in itself, this approach will demand greater convergence in how competent authorities approach supervision. The FSA's model, on which the MiFID Review is based, reflects parallel changes to how the FSA approaches retail market conduct risk under its Intensive Supervision model;[31] the largest firms can expect a 'very intensive and intrusive assessment of their governance processes and the products that these deliver'.[32] If this approach is to be

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[25] E.g., European Commission, *Communication on Crisis Resolution* (COM(2010) 579), setting out the Commission's agenda for crisis resolution mechanisms, and DG Internal Market and Services, Working Document, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution*, January 2011.

[26] Directive 2009/111/EC, *OJ* 2009 L 302/97.

[27] Directive 2009/65/EC, *OJ* 2009 L 302/32, Arts. 19 and 20.

[28] FSA, Discussion Paper 11/1, *Product Intervention* (2011).

[29] European Commission, *Public Consultation. Review of the Markets in Financial Instruments Directive*, December 2010 (MiFID Review).

[30] Ibid., at pp. 68-69.

[31] On Intensive Supervision and the related Supervisory Enhancement Programme, see (initially) FSA, *The Turner Review. A Regulatory Response to the Global Banking Crisis* (2009), at pp. 86-91, and FSA, Discussion Paper 09/2, *A Regulatory Response to the Global Banking Crisis* (2009), ch. 11. More recently, see FSA, *2010/2011 Business Plan*, at p. 9, FSA, *Business Plan 2011-2012*, at p. 27 (prudential supervision) and p. 45 (market supervision), and Speech by FSA Chief Executive Sants on 'Reforming Supervisory Practices: Practical Progress to Date', Reuters Newsmakers Event, 13 December 2010, available at: <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/1213_hs.shtml>.

[32] *Supra* n. 28, at p. 35.

adopted pan-EU and post-MiFID Review, close attention will be required to supervisory practices and supervisory resourcing. It is the establishment of ESMA, however, which has the most significant implications for supervision (section 2).

1.3 The implications

Part 1 suggested that the primary question for EU financial market scholarship with respect to law-making concerns the relative efficiency of the EU and its Member States as law-maker(s) for the EU financial market. Supervision prompts the same question, although difficult issues of task allocation also arise, given the different operational supervision, crisis management and supervisory convergence aspects of supervision. While a strong case can be made for the EU to act as the primary rule-maker for EU financial markets, the intensification of the EU's influence on supervision and on how outcomes are achieved poses a number of challenges. Efficiencies follow from a more effective system for supervisory coordination given the prevalence of pan-EU actors and heightened possibilities for risk transmission. Competent authorities may benefit from importing a set of harmonised operational supervisory practices as rules become more complex and the political demands on supervisors, facing a 'never again' zeitgeist, become more intense. ESMA may prove efficient in discovering optimum supervisory practices, and may cut through the pre-ESMA informal network-based system which allowed for flexibility, experimentation and learning, but which took time. But there are significant challenges.

The EU's experience with operational supervision and with related institutional reform is limited. CESR is the obvious precedent. While CESR was largely focused on 'rules on the books', its guidance had implications for operational supervision. CESR recommended, for example, that a mixed risk-based and sampling approach should be adopted with respect to financial information rules.[33] But CESR was largely concerned with establishing the reach of EU rules and consensus positions on their interpretation and not with how to achieve convergence on the granular elements of supervision. Its peer review exercises, for example, mostly aimed at assessing formal powers on the books rather than at operational supervision,[34] and did not yield strong results.[35] With respect to coordination, while CESR made efforts in the field of mediation, delegation and information sharing, and established structures for supporting supervisory coordination in regard to market abuse (CESR-Pol) and financial information (CESR-Fin),[36] its activities were generally limited. As a result, the EU has little to draw on in terms of prior experience either with

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33 CESR, *Standard No. 1 on Financial Information*, Principle 13 (CESR/03-073).

34 The market abuse regime exercises (CESR/10-262, CESR/09-1120 and CESR/07-380), e.g., focused for the most part on the formal powers which supervisors can exercise, rather than on the operational exercise of these powers.

35 *Infra* n. 109.

36 Moloney, *supra* n. 14, at pp. 1127-1132.

centralised models for coordination or with the setting of standards for operational supervision.

Few international templates are available as to how coordination and operational convergence can be organised cross-border. International bodies have traditionally not overly concerned themselves with operational supervision. 'Big ticket' coordination issues, including crisis management and the operation of international colleges of supervisors, and with respect to systemically important financial institutions, have received close attention in the wake of the crisis in a number of fora, most notably the Financial Stability Board. But there has been less interest in the day-to-day business of financial market supervision and in the implementation of standards,[37] perhaps as the soft law standards produced by international standard-setters might be regarded as popular precisely because they allow states and regulators to 'under-enforce' and so defect from these commitments.[38] IOSCO has been primarily concerned with cross-border supervisory cooperation and coordination (through its multilateral Memorandum of Understanding in particular).[39] While a more operational theme is emerging from IOSCO initiatives,[40] particularly with respect to emerging markets,[41] it has generally not engaged closely with operational matters. The Financial Stability Board may play a larger role in the development of supervisory best practices, particularly through its evolving role in peer review of standard implementation.[42] But the array of local and path-dependent factors which feed into the achievement of supervisory outcomes make it unlikely that sensible templates can be developed internationally.

ESMA's adoption of operational standards for Member States' competent authorities and for the exercise of its direct powers raises further difficulties. ESMA

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[37] The Pittsburgh G20 conclusions, e.g., were broadly concerned with regulatory reform: Pittsburgh G20 Meeting, Leaders' Statement on 'Strengthening the International Financial Regulatory System', available at: <http://www.pittsburghsummit.gov/mediacenter/129639.htm>.

[38] C. Brunner, 'Why Soft Law Dominates International Finance – And Not Trade', 13 *Journal of International Economic Law* (2010) p. 623, at p. 636.

[39] E.g., IOSCO, *Principles Regarding Cross-border Supervisory Cooperation* (2010). See D. Langevoort, 'U.S. Securities Regulation and Global Competition', 3 *Virginia Law & Business Review* (2008) p. 191, noting the difficulties in moving from standard-setting to enforcement.

[40] Its 2009 review of 'fit and proper' standards, e.g., examines the best supervisory practices in this area: IOSCO, *Fit and Proper Assessment, Best Practice Report* (2009).

[41] It has recommended, e.g., that emerging market regulators adopt a risk-based supervisory approach: IOSCO, *Guidelines to Emerging Market Regulators Regarding Requirements for Minimum Entry and Continuous Risk-Based Supervision of Market Intermediaries* (2009).

[42] FSB, *Framework for Adherence to International Standards* (2010). Peer review of the FSB executive compensation standards has taken place: FSB, *Thematic Review on Compensation. Peer Review Report* (2010). Peer review reports were also issued in March 2011 on risk disclosures and on residential mortgage underwriting. More generally, the FSB has undertaken a peer review programme to review actions taken by national authorities to address IMF/World Bank recommendations concerning financial regulation and supervision under the Financial Sector Assessment Programmes.

is likely to develop templates for operational supervision from experience in different jurisdictions. But the way in which supervision is delivered reflects a range of different factors (from an institutional perspective, these include organisational structure, degree of independence, nature of powers, organisational dynamics and incentives, and resourcing, for example), which differ across supervisory regimes.[43] The outcomes achieved from the mix may not necessarily be the product of clearly observable factors, but can reflect how the supervisor engages with the regulated sector and the wider environmental factors which bear on this relationship.[44] The UK FSA's Turner Review, for example, attempted to benchmark the FSA's post-crisis supervisory model against international comparators, but concluded that the crisis had not identified which supervisory models were best equipped to deal with the crisis, given the range of political, market, regulatory, societal and other variables which influence supervision.[45] It is therefore difficult to ascertain which factors lead to strong supervisory outcomes. It is likely to be perilous to export models to different jurisdictions and, in particular, to detach different elements from a particular supervisory matrix and to apply it on a pan-EU basis. For example, supervision is currently delivered across the EU through a wide range of institutional structures (consolidated, twin-peak-based and sectorally split structures).[46] These are exposed to different effectiveness risks (including with respect to organisational dynamics and incentives)[47] and will engage with supervisory practices in different ways.[48]

Further difficulties arise. Nimble and imaginative supervision can act as a safety valve which releases some of the pressure generated by regulatory homogeneity. Financial market regulation is becoming more homogenous, both in the EU and internationally. Supervision may therefore become a defence against systemic regulatory error, as well as a key instrument of competition between and discipline on supervisors. While it has since come under pressure,[49] the UK FSA's 'Treating Customers Fairly' supervisory model,[50] for example, allowed the FSA to calibrate the impact of MiFID on the UK's retail investment product market, which has distinctive

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43 *Supra* n. 9.

44 R. Baldwin and J. Black, 'Really Responsive Regulation', 71 *Modern Law Review* (2008) p. 59.

45 *Supra* n. 31, at pp. 89-90.

46 Ferran, *supra* n. 1, at pp. 6-9, and Wymeersch, *supra* n. 9.

47 E.g., E. Pan, 'Four Challenges to Financial Regulatory Reform', 55 *Villanova Law Review* (2009) p. 101.

48 See further, N. Moloney, 'Monitoring Regulation: The Difficulties of Achieving "Law in Action" and the EU Challenge', in K. Hopt, G. Ferrarini and E. Wymeersch, eds., *Financial Regulation and Supervision in the New Financial Architecture* (Oxford, OUP, forthcoming 2011).

49 N. Moloney, 'Regulating the Retail Markets: Law, Policy and the Financial Crisis', in G. Letsas and C.O. Cinneide, eds., *Current Legal Problems 2010* (Oxford, OUP 2010) p. 375.

50 E.g., J. Black, M. Hopper and C. Band, 'Making a Success of Principles-Based Regulation', 1 *Law and Financial Markets Review* (2007) p. 191.

features.[51] Differential supervision may provide a mechanism for injecting some flexibility and innovation into the ever-intensifying rule-book as self-regulation retreats. Careful and calibrated supervision may also provide some protection against firms, in an increasingly standardised regulatory environment, adopting in response similar business models which can generate systemic risk; the large-scale homogeneity of losses from exposure to securitised debt was a major source of systemic risk over the crisis. Although structures are being put in place post-crisis to monitor systemic risk, they remain untried, and much will depend on the effectiveness of local supervision and on its ability to respond to particular firm risks.[52]

Experimentation and flexibility are all the more necessary as effective supervision is not easy to achieve. The different elements of effective supervision in practice are many and complex and reflect local experience and supervisory learning. The FSA's supervisory approach, for example, has changed significantly in the wake of the crisis following the adoption of the Intensive Supervision model. Retail markets supervision has undergone a related radical change from a predominantly disclosure and distribution-based approach to a more intensive and intrusive one which is designed to lead to early risk identification and proactive intervention.[53] The proposed Financial Conduct Authority (previously termed the Consumer Protection and Markets Authority and which, with the proposed Prudential Regulatory Authority, will shortly replace the FSA) will be charged with undertaking comprehensive risk analysis in the retail markets and with following an issues-based approach to supervision, in parallel with intensive firm-facing supervision.[54] The particular elements of this approach are many and sophisticated. The UK FSA's recently unveiled product intervention strategy, for example, highlights early identification of conduct risk (conduct risk specialists have been recruited[55]), retail conduct risk outlook analysis, business model and strategy analysis, and an intensive supervisory approach.[56] But this new approach, which promises much for the retail market and elements of which are appearing in the MiFID Review, reflects long difficulties with mis-selling in the UK retail markets, the spill-over of the Intensive

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[51] N. Moloney, *How to Protect Investors. Lessons from the EU and the UK* (Cambridge, CUP 2010), ch. 4.

[52] Similarly, R. Romano, 'Against Financial Regulation Harmonization: A Comment' (2010), available at: <http:/ssrn.com/abstract=1697348>.

[53] Key staging posts include: FSA, *Retail Conduct Risk Outlook* (2011), and FSA, *Business Plan 2010/2011.*

[54] HM Treasury, *A New Approach to Financial Regulation: Building a Stronger System* (2011), at pp. 69-70.

[55] Speech by FSA Director of Conduct Policy Sheila Nicoll on 'Product Intervention and EU Engagement: Two Key Strands of Our Consumer Protection Strategy,' Copenhagen, 26 January 2011, available at: <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/0125_sn.shtml>.

[56] FSA, *supra* n. 28, at pp. 32-42.

Supervision model adopted in response to the prudential risks which the financial crisis exposed, and a change in the FSA's tolerance of the levels of detriment which can be sustained in the consumer market.

The process through which supervisory outcomes are achieved also depends in part on the particular supervisory style relied on and these styles – whether, for example, outcomes-based, principles-based, risk-based or, most likely, a combination of all (to identify styles *in vogue* pre-crisis) – involve different risks, demand sophisticated supervisory engagement and change in response to market developments. Principles-based regulation, for example, now faces an uncertain future.[57]

Difficult choices must also be made as to resource allocation. Supervisors operating with finite resources, subject to information asymmetries, and in a complex regulatory and market environment must, for example, make choices about the extent to which they will 'enrol' market actors in the supervisory process.[58] Prior to the financial crisis, considerable weight was given by some supervisory models to internal systems-and-controls-based supervision. The FSA's supervisory model, for example, largely focused on ensuring that firms had appropriate systems and controls. This model was based on the assumption that primary responsibility for risk should lie with senior management of financial institutions and that supervision should focus on systems and processes rather than on overall business models.[59] In the wake of the crisis, however, the FSA moved to its Intensive Supervision model, which involves a shift away from relying on internal systems and controls and on management judgment and towards challenging business models and modelling, and reacting to, potential risks.[60]

Where operational standards are harmonised it becomes all the more difficult for competent authorities to experiment, learn and adapt. Recent statements in the UK are revealing. In 2010, FSA Chief Executive Sants noted that 'the FSA's effectiveness should thus [given international rule harmonisation] primarily be judged on the effectiveness of our supervision and not the quality of the rules'.[61] In the 2011/2012 FSA Business Plan it was noted that the ESAs had left 'the FSA and its successor bodies primarily acting in a policy-influencing and national supervisory role' and that the FSA had become 'the supervisory arm of a European rule-making

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[57] On the risks of different styles of regulation, and lessons from the crisis, see J. Black, 'The Rise, Fall and Fate of Principles Based Regulation' (2010), available at: <http://ssrn.com/abstract=1712862>.

[58] Black, *supra* n. 11.

[59] Turner Review, *supra* n. 31, at p. 87.

[60] FSA Chief Executive Sants has acknowledged that 'the historic FSA strategy of focusing on high-level systems and controls [and information disclosure to consumers] has not proved effective': Sants, *supra* n. 31.

[61] Speech by FSA Chief Executive Sants on 'UK Financial Regulation: After the Crisis,' 12 March 2010, available via: <http://www.fsa.gov.uk/Pages/Library/index.shtml>.

process'.[62] HM Treasury, in a February 2011 policy document on the upcoming changes to the institutional structure of supervision, noted that 'day-to-day supervision of financial institutions will remain at the national level, ensuring that national governments retain their frontline responsibility to protect national tax payers' interest'.[63] These comments underline the emphasis which the FSA and the UK government are placing on the ability of national supervisors to deliver outcomes for their markets through operational supervisory strategies. But the potential influence of ESMA on supervision may limit local operational discretion and flexibility considerably in practice, as now seems to be recognised within the FSA.[64]

All these difficulties are exacerbated as complex questions of degree arise with respect to the institutional shape of EU-led supervision, given the 'top down' and 'bottom up' dynamics and the related momentum effects. From a 'top down' perspective, the financial crisis has exposed the risks which follow where cross-border actors are not subject to coordinated supervision, coordinated emergency action cannot be taken and pan-EU monitoring of risk is limited. But the centralisation of emergency powers demands an institutional structure of some sort. Considerable momentum risks then arise in relation to the more workaday operational powers which can be subsequently granted to, or organically acquired by, the new structure. From a bottom-up perspective, greater sharing of best practices and stronger peer discipline can strengthen pan-EU financial market supervision. But operational supervision of market actors should remain at Member State level (section 2.10 below). Designing a system which supports some degree of operational centralisation, retains the power of national supervisors and supports greater convergence, all the while preventing an undue leakage of power from the Member States, was never going to be easy.

The difficulties are all the greater given the financial stability agenda which has driven the new structure. ESMA is a product of an institutional and political concern to manage the wider prudential and systemic risks which the financial crisis exposed; the final institutional trilogue (Commission/Council/Parliament) negotiations over summer 2010, for example, focused on the EBA template. But securities markets remain different to banking markets,[65] and the financial stability risks which currently frame the scholarly and policy debate, while common to all market segments, are stronger in the banking markets than in the securities markets. As the crisis has made clear, the risks which cross-border banking can generate, including with respect to a withdrawal of liquidity from host states and risk transmission across

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[62] FSA, *Business Plan 2011/2012*, at pp. 9 and 25.

[63] *Supra* n. 54, para. 7.7.

[64] Ferran has noted the FSA's concern on this point: *supra* n. 1, at pp. 44-45.

[65] D. Langevoort, 'Global Securities Regulation after the Financial Crisis', 13 *Journal of International Economic Law* (2010) p. 799, 'slicing' securities regulation into the components which are amenable to international convergence and identifying prudential-related risk regulation as an area appropriate for convergence.

transnational groups,[66] are acute and demand sophisticated management. Securities markets can also transmit systemic risk. Different practices, such as proprietary dealing, and different structures, such as central clearing counterparties (CCPs), have been associated with the financial crisis; so too has the wider failure of securities markets to price risk effectively.[67] It is also the case that silo-based regulation struggles to capture the interconnected and complex nature of risk and that securities regulators need to become better at managing systemic risk.[68] Nonetheless, certain cross-border financial market actors (such as issuers) do not transmit systemic risk cross-border to the same degree as systemically important financial institutions. But reflecting the spill-over dynamics which are a long-standing feature of EU financial markets law, the financial stability agenda will lead to ESMA exercising significant operational control over all aspects of the securities markets, including the disclosure, transparency and market abuse spheres which have been less to the fore over the financial crisis.

It seems reasonable, accordingly, that ESMA's supervisory powers should be carefully confined and national supervisory discretion protected. But the hesitancy which characterises ESMA's law-making powers is not in evidence with respect to its supervisory powers. In terms of coordination, it wields an array of powers of increasing intensity which culminate in ESMA's ability to supplant national supervisors. In terms of operational convergence, ESMA's ability to shape supervisory practice is considerable. Ultimately, local supervisory discretion and flexibility may be placed under undue pressure to the detriment of effective local supervision and pan-EU supervisory learning. ESMA's extensive direct supervisory powers may also lead to sub-optimal outcomes. ESMA's supervisory powers are examined in the following section.

2. ESMA's SUPERVISORY POWERS

2.1 Coordination: in crisis and in normal conditions

Initiatives to ensure better supervisory coordination in a crisis are a central element of the financial stability agenda. ESMA has accordingly been conferred with a range of soft coordination and monitoring powers with respect to systemic risk manage-

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66 G. Ferrarini and F. Chiodini, 'Regulating Multinational Banks in Europe. An Assessment of the New Supervisory Framework' (2010), available at: <http://ssrn.com/abstract=1596890>, and K. Pistor, 'Host's Dilemma: Rethinking EU Banking Regulation in the Light of the Global Financial Crisis' (2010), available at: <http://ssrn.com/abstractid=1631940>.

67 E.g., Turner Review, *supra* n. 31, at pp. 11-49.

68 E.g., IOSCO, *Managing Systemic Risk. A Role for Securities Regulators* (2011), noting the traditional focus of securities regulators on market efficiency, fairness and transparency, and their reliance on disclosure-based and conduct-based techniques, but calling for a sharper focus on systemic risk.

ment and cross-border resolution, which are broadly concerned with the development of new structures in cooperation with other EU institutions (ESMA Regulation, Articles 22-27). Its related responsibilities include monitoring market developments and, in coordination with the ESRB, initiating and coordinating assessments of the resilience of market participants (Article 32). It has a general coordination role under Article 31, which empowers ESMA to promote a coordinated EU response to crisis situations by, *inter alia*, facilitating information exchange, verifying the reliability of information and notifying the ESRB of potential emergency situations. In an 'emergency' situation under Article 18(1) (section 2.5 below) ESMA is to facilitate actively and, where necessary, coordinate competent authority action in cases of adverse developments which may seriously jeopardise the orderly functioning and integrity of financial markets or the stability in whole or part of the EU financial system.

Crisis coordination apart, ESMA is to 'stimulate and facilitate' the delegation of supervisory tasks and responsibilities between competent authorities (Article 28). The 'supervisory culture' activities engaged in by CESR are also ESMA's responsibility. Under Article 29 it is to play an active role in building a common EU supervisory culture and consistent supervisory practices through, for example, providing opinions to competent authorities, supporting information exchange and establishing training programmes.

Reflecting current EU policy, and by contrast with CESR, ESMA will also have a prominent operational role in colleges of supervisors.[69] The 2009 CRD II requires that supervisory colleges be established, their roles be clarified and a larger role be given to the supervisors of systemically significant branches in colleges,[70] while the Commission's 2010 Communication on crisis resolution proposes 'resolution colleges'.[71] ESMA is likewise conferred with a range of powers to support supervisory colleges. It is to contribute to promoting and monitoring colleges of supervisors and to participate in college activities, including on-site examinations (Article 21(1) and (2)). ESMA may establish and manage information systems for colleges, initiate EU stress tests and evaluate systemic risk, and oversee the tasks carried out by competent authorities. ESMA may also request further deliberation by a college where it considers a college decision would lead to an incorrect application of EU law or not contribute to convergence in supervisory practices (Article 21(2)). As discussed in section 2.5, ESMA has the power to address decisions to supervisors where mediation fails (Article 19). The 2010 Omnibus Directive also revises the main financial market measures to confer on ESMA a range of powers to support supervision by colleges, including direct participation in joint investigations.[72]

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[69] The ESMA FAQ highlights ESMA's 'important role' in colleges of supervisors (at p. 8).

[70] Directive 2009/111/EC, *OJ* 2009 L 302/97.

[71] COM(2010) 579.

[72] E.g., Prospectus Directive (Omnibus Directive, Art. 5(10)) and MiFID (Omnibus Directive, Art. 6(22)).

2.2 Operational convergence and direct supervision

But it is where ESMA's powers move beyond coordination and into day-to-day operational matters that the real impact on local supervisory powers can be seen and where Member State safety valves in the form of operational supervisory discretion and decision-making are being closed. Although ESMA forms part of the ESFS, which includes the local competent authorities (Article 2) that are responsible for day-to-day supervision (recital 9), the extent of ESMA's powers raises the risk that local competent authorities may, in time, become technical functionaries of ESMA.

ESMA looks set to develop a best practice model for operational supervision. The DLG Report, for example, called for competent authorities' competences and powers to be aligned to the 'most comprehensive system in the EU',[73] the European Council called for an upgrading of the quality and 'consistency' of national supervision,[74] ECOFIN charged the new Authorities with ensuring that 'consistent supervisory practices' are applied and with ensuring 'a common supervisory culture and consistent supervisory practices',[75] and the Commission's original proposal for the 2010 ESMA Regulation called for it to take an active role in ensuring uniform procedures and consistent supervisory practices. On the Parliament's September 2010 vote to adopt the new structure, a combined statement from the Chairpersons of the 3L3 committees noted their commitment to upgrade the quality and consistency of supervision.[76] Similarly, Commission President Barroso highlighted that the new Authorities would work with national supervisors 'to improve the day to day oversight of individual firms'.[77] While an improvement in supervisory practices is a laudable aim, the extent of ESMA's convergence powers (outlined in the following sections), combined with its direct supervisory powers, may lead to a loss of discretion, flexibility, innovation and experimentation in the supervisory system.

2.3 Convergence: supervisory practices

The power to propose binding technical standards (BTSs) gives ESMA considerable potential to shape operational decision-making. Hitherto, EU rule-making has not closely engaged with process, although elements of process-based harmonisation, from a firm-facing perspective, can be seen in MiFID's best execution regime and in the proposed new regime for product governance in the MiFID Review. CESR was beginning to promote convergence in supervisory decision-making through, for example, its 'Accepted Market Practices' regime which governs how supervisors

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73 *Supra* n. 6, at p. 49.

74 European Council, Presidency Conclusions, 18-19 June 2009.

75 2948th ECOFIN Meeting, June 2009.

76 CESR, CEBS and CEIOPS, '3L3 Committees Welcome European Parliament Landmark Vote to Reform Financial Supervision in Europe', 22 September 2010.

77 Commission Press Release, MEMO/10/436, 22 September 2010.

decide which practices can be deemed 'AMPs' and so exempt from the market abuse regime.[78] Its efforts to promote convergence with respect to how issuers' financial information is reviewed were similarly concerned with supervisory decision-making and the use of risk-based techniques.[79] The new generation of BTSs are likely to drill much deeper into supervisory practices. Many delegations to BTSs under the Omnibus Directive are concerned with supervisory coordination and information sharing.[80] But many involve local supervisory decision-making. BTSs will be produced, for example, on the detailed information which competent authorities should require prior to investment firm authorisation and on when supervisors should demand a supplementary prospectus under the prospectus regime.[81] ESMA's ability to request information from local competent authorities will also strengthen its ability to produce operational BTSs by enhancing its local knowledge. Competent authorities are subject to extensive obligations to provide information to ESMA concerning their practices,[82] including with respect to all administrative measures and sanctions imposed.[83]

ESMA's specific coordination powers are also likely to influence operational decision-making and supervisory practices at national level. MiFID, for example, will require that Member States, coordinated by ESMA, are to ensure that appropriate measures are in place to enable competent authorities to monitor the activities of investment firms to ensure they act honestly, fairly and professionally and in a manner that promotes the integrity of the market (Omnibus Directive, Article 6(9)).

There is also some evidence emerging that ESMA may have a more general ability to shape supervisory practices with respect to the emerging 'crisis era' measures. The Short-Selling Proposal requires that ESMA be notified in advance where a competent authority plans to impose exceptional disclosure obligations on holders of short positions, restrict or prohibit short sales, or restrict credit default

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[78] CESR/04-505.

[79] CESR, *Standard No. 1 on Financial Information*, *supra* n. 33.

[80] E.g., BTSs are to be adopted specifying the templates for information to be transferred in the context of home/host notification of passporting firms under MiFID (Omnibus Directive, Art. 6(12)).

[81] Omnibus Directive, Arts. 6(2) and 5(7).

[82] The information transmittal obligations are extensive. Under the Short-Selling Proposal (COM(2010) 482), e.g., ESMA must be notified of: the short-selling and credit default swap (CDS) notifications made to competent authorities (Art. 11); prohibition decisions and other enforcement measures, before the decision is intended to take effect (Art. 22); and cooperation agreements with third countries (Art. 32). The Prospectus Directive, e.g., will require, *inter alia*, that prospectus approval decisions and transfers of home authority approval powers are notified to ESMA (Omnibus Directive, Art. 5(5)).

[83] The Market Abuse Directive, e.g., will require that ESMA be provided with aggregated information concerning all administrative measures and sanctions imposed (Omnibus Directive, Art. 3(4)), as will MiFID (Omnibus Directive, Art. 6(18)).

swap (CDS) transactions, in each case in accordance with the proposed new regime. ESMA must issue an opinion (publicly disclosed) within 24 hours on whether it considers that adverse developments have arisen which constitute a serious threat to financial stability or market confidence, whether the measure is proportionate and appropriate, and whether its duration is justified (Articles 22 and 23). Where the authority proposes to take action contrary to the ESMA opinion (or declines to take measures), it must publicly disclose its reasoning for doing so. Article 23 similarly requires ESMA to facilitate and coordinate action by local competent authorities under the Proposal and to ensure that a 'consistent approach' is adopted. ESMA is also empowered to conduct enquiries into issues related to short-selling and CDSs (Article 28). In addition to its powers of direct intervention (section 2.9 below), ESMA is accordingly placed at the centre of highly sensitive decisions by competent authorities with respect to short-selling and is likely to have significant influence on how the regime develops operationally.

A similar effect may flow from the proposed 2011 AIFM Directive.[84] The highly sensitive regime for alternative investment fund leverage includes a direction to competent authorities to impose leverage limits where necessary under the terms of the Directive (Article 25). ESMA, however, must be notified before the limit is imposed and is to perform a facilitation and coordination role in order that a consistent approach be adopted by competent authorities. ESMA must also issue advice to the competent authority concerning the limits; where this advice is ignored, ESMA may make public disclosure to this effect. The Directive also gives ESMA a significant role with respect to the supervision of non-EU alternative investment fund managers (AIFM). In particular, ESMA must advise on authorisation decisions concerning non-EU AIFM and, where a competent authority proposes to authorise contrary to ESMA's advice, this course of action must be publicly disclosed by ESMA (Article 35d).

ESMA's potential influence on supervisory decision-making can also be seen from its insertion into cross-border inspections and investigations. The Short-Selling Proposal, for example, requires that ESMA coordinate any investigation or inspection with cross-border effects (Article 31), while the Prospectus Directive, following the Omnibus Directive reforms, will empower ESMA to participate in on-site inspections carried out by two or more competent authorities (Article 5(10)). Similarly, its role in colleges of supervisors is likely to increase its influence on supervisory practices. As noted above, ESMA is to participate in the activities of colleges of supervisors (ESMA Regulation, Article 21). It is also being conferred with more specific powers in colleges of supervisors. The OTC Derivatives Proposal[85] gives ESMA a central role in the

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[84] T7-0393/2010 (first Parliament reading, November 2010, based on the previously brokered 'political agreement'), based on Commission Proposal COM(2010) 289. Publication in the Official Journal is expected in summer 2011.

[85] COM(2010) 484.

college of competent authorities responsible for the authorisation of CCPs (Articles 14 and 15).

There are multiple avenues therefore which ESMA can follow to influence operational supervisory decision-making, with a consequent risk to flexibility and innovation and with greater pressure being placed on ESMA's effectiveness as a supervisor. Operational decision-making may be subject to further standardisation as a result of the peer review mechanism, outlined in the next section.

2.4 Convergence: peer review

Reflecting international trends post crisis and in particular the work of the Financial Stability Board,[86] ESMA is conferred with peer review powers. Under ESMA Regulation Article 30, ESMA is to engage in peer review of competent authorities' activities to further strengthen consistency in supervisory outcomes. ESMA peer review is also becoming a feature of EU financial market regulation more generally; the proposed 2011 AIFM Directive grants ESMA a specific peer review function with respect to how competent authorities supervise non-EU alternative investment fund managers (Article 35e). The 2010 Communication on sanctions similarly calls on ESMA to include sanctioning powers as a priority area for review.[87]

ESMA peer review is concerned with the 'capacity of supervisors to achieve high quality supervisory outcomes', including with respect to the adequacy of resources and governance arrangements, capacity to respond to market developments, degree of convergence in the application of EU law and in supervisory practices, and best practices (recital 41 and Article 30). Competent authorities are under an obligation to 'endeavour to follow' the outcomes. The results of the peer review may also be disclosed publicly, subject to the agreement of the relevant authority.

A peer review function appears relatively benign, but it may lead to undue standardisation. The different supervisory styles, for example, employed by supervisors are context dependent. The FSA's post-crisis Intensive Supervision model reflects, variously, relatively long experience with the risk-based ARROW model for supervision, the deterrent effect of a potential (now actual) FSA restructuring in the wake of the crisis, and long struggles with achieving effective 'law in action' in the retail markets given an array of mis-selling scandals. As applied in the retail markets, it reflects a change in the FSA's tolerance of the amount of detriment which consumers can be expected to bear,[88] as well as a sharper focus on the retail markets generally, with the proposed Financial Conduct Authority being designated a 'consumer champion'.[89] Transplantation of this model would be neither

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[86] *Supra* n. 42.
[87] COM(2010) 716, at p. 16.
[88] See, e.g. FSA, *supra* n. 28, at pp. 20-21.
[89] HM Treasury, *supra* n. 54, at p. 60.

desirable nor possible, not least given the different priorities which different supervisors attach to different market segments and the different approaches they can take to the degree of risk and failure they are prepared to tolerate.[90] Similarly, risk-based supervision[91] is common across Member State supervisors,[92] with the FSA[93] and the Dutch prudential regulator[94] being well-known exponents of this model. But risk-based supervision requires the supervisor to make sensitive decisions as to the level of failure it is prepared to tolerate; ESMA intervention to this effect could be troublesome, not least as fiscal risk-bearing remains at national level.

Similar concerns arise with respect to resourcing. It is clear from recent annual reports of the EU's major supervisors that resources are being increased; the French AMF (along with CONSOB[95] and BaFIN[96]) is recruiting more and specialised staff,[97] while FSA resources have been significantly increased.[98] But it is happening to varying extents, in different ways, and reflecting how supervisors, in distinct market and political contexts, have reacted to the crisis. The recent increase in the FSA's staffing, for example, is related in part to the demands of its Intensive Supervision model.[99] Internal organisational dynamics are also key to effective resourcing; the FSA's 2010-2011 Business Plan underlined the need for it to embed the organisational and cultural change needed to implement Intensive Supervision and to develop a more responsive, decentralised decision-making structure.[100] Institutional design and the related institutional culture similarly play a very large role in the effective deployment of resources; no single model prevails across the EU. Simple increases in staff numbers alone will also achieve little where staff are poorly

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[90] At an early stage, CESR noted divergences across the national competent authorities with respect to the purposes of financial market regulation: Himalaya Report, *supra* n. 15.

[91] E.g., *supra* n. 8.

[92] CESR/08-220, at pp. 7-8 (in the context of the MiFID mapping exercise and reporting that 19 supervisors adopt some form of risk-based supervision). E.g., CONSOB, *Annual Report* (2008), at p. 103, highlighting CONSOB's risk-based approach to supervision, and BaFIN, *Annual Report* (2008), at pp. 125-130, explaining how BaFIN applies a risk-based model to the banking sector.

[93] Its risk-based approach is set out in its ARROW supervisory model (ARROW II) under which the FSA allocates supervisory resources according to a scoring system.

[94] DNB, 'DNB's Vision of Supervision in 2006-2010', *DNB Quality Bulletin* (2006) p. 54.

[95] *Annual Report* (2008), at pp. 18-19.

[96] *Annual Report* (2008), at p. 221.

[97] E.g., AMF, *Better Regulation: Initial Assessment and 2008/2009 Work Agenda* (2008), at p. 1.

[98] FSA resourcing levels climbed significantly in the wake of the crisis, with a projected increase of 460 staff and a 9.9% increase in its annual funding requirement: FSA, *Business Plan 2010/2011*, at p. 54. The Annual Report for 2009-2010 reported that 537 staff had been added to supervisory and specialist units: at p. 11.

[99] 'This proactive approach to supervision requires significantly more people than the old reactive model and those individuals must be of a higher quality and supported by more sophisticated systems. If society wants a more proactive approach it must accept that it will have a larger and more expensive regulator': FSA Chief Executive Sants, commenting on the 2010-2011 Business Plan.

[100] FSA, *Business Plan 2010-2011*, at p. 11.

qualified and have few positive incentives.[101] The range of difficult issues which optimum resourcing generates suggests that peer review in this area will demand considerable sensitivity to local supervisory contexts.

Very large questions also arise as to how the outcomes against which peer review takes places are set in an environment characterised by diverging market profiles, different national priorities, and potential tensions between competent authorities, the ESAs and the ESRB, particularly given the failure to identify any of the governing principles of EU financial market law[102] (although ESMA's list of objectives represents an improvement in this regard (ESMA Regulation, Article 1(5))). Competent authorities are subject to a range of similar, but subtly varying, supervisory mandates which shape outcomes.[103] The FSA's statutory objectives, for example, have shaped the UK regulatory environment while broader goals, including with respect to redistribution, have influenced the development of the US system.[104] How is peer review best conducted with differing supervisory mandates, given the impact different objectives can have on supervisory approaches? Will it, for example, be legitimate for competent authorities to prioritise certain market segments, reflecting local market conditions, including variations in the strength of market discipline? Competing objectives pose difficulties at national level;[105] they are all the more complex at supranational level. In particular, what if national retail market protection objectives were to lead to conflict with pan-EU solvency and stability objectives?[106]

Internationally, the Financial Action Task Force's Mutual Evaluation Process, with respect to money laundering and terrorism financing, is regarded as successful. But it is backed by a sophisticated structure for peer review[107] and takes place in a particular political and supervisory context; there are strong incentives not to be regarded as weak in addressing money laundering or terrorism financing. And even here, the review process has been described as 'resource intensive and sometimes

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101 As noted by Jackson and Roe, s*upra* n. 9.

102 Moloney, s*upra* n. 14, at pp. 1095-1097.

103 For a summary, see E. Hüpkes, M. Quintyn and M. Taylor, 'The Accountability of Financial Sector Supervisors – Principles and Practice', 16 *European Business Law Review* (2005) p. 1575, at p. 1585.

104 Jackson (2005), s*upra* n. 9.

105 Considerable efforts are being made in the UK to clarify the different strategic objectives, operational objectives and regulatory principles which will govern the proposed Prudential Regulatory Authority and the Financial Conduct Authority: HM Treasury, s*upra* n. 54, at pp. 45-48 and 61-66.

106 Consumer protection and stability conflicts were of particular concern in the US during the negotiations on the Dodd-Frank Act 2010 over the (ultimate) location of the Bureau of Consumer Financial Protection within the Federal Reserve. E.g., J. Coffee and H. Sale, 'Redesigning the SEC – Does the Treasury Have a Better Idea?', 95 *Virginia Law Review* (2009) p. 707.

107 E.g., FATF, *Methodology for Assessing Compliance with the FATF 40 Recommendations and the FATF Special Recommendations* (2004, updated 2009), and FATF, *AML/CFT Evaluations and Assessments. Handbook for Countries and Assessors* (2009).

painful'.[108] This is not to argue against peer review, but to suggest that considerable care will be needed in how it is implemented if undue standardisation is to be avoided.

2.5 Direct supervision: the ESMA Regulation and directing local supervisors

ESMA's controversial powers to 'address decisions' to competent authorities (in effect, overrule them) arise in three situations: where a breach of EU law has occurred (Article 17) (ESMA action takes the form of a 'recommendation' in this case); in 'emergency situations' (Article 18); and where disagreements arise between supervisors and ESMA action is provided for in the relevant measure (Article 19).

Article 17 represents a significant enhancement of the weak peer review mechanisms previously used by CESR to support compliance.[109] It concerns breaches of ESMA-scope EU law (including any related delegated rules, and in particular with respect to competent authorities' failures to ensure financial market participant compliance). It empowers ESMA to undertake investigations, make recommendations and ultimately address decisions to market actors, subject to strict time limits. As interpreted by ESMA, the new procedure 'is intended to place the national competent authority under considerable pressure more quickly'.[110] ESMA is first empowered to investigate alleged breaches of EU law by a competent authority (on its own initiative or following a request by a national authority, the Parliament, Commission, Council or its stakeholder group). Not less than two months after initiating the investigation, ESMA may issue a 'recommendation' to the authority, setting out the remedial steps necessary. Where the authority does not comply within a month of the recommendation (it should inform ESMA of the steps it is to take within ten days of receipt), the Commission (on its own initiative or after notification by ESMA) may issue a formal opinion (within three months of the ESMA recommendation), taking into account ESMA's recommendation, requiring the authority to take the necessary remedial action. Within ten days of receipt of the opinion, the authority must inform the Commission and ESMA of the steps it has

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[108] Speech by FATF President Vlaanderen on 'The Challenge of Compliance with the FATF Standards', 3 June 2010, available via: <http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236879_1_1_1_1_1,00.html>.

[109] Reviews of the UCITS passporting regime (CESR/09-1034) and CESR's Standards Numbers 1 and 2 on financial information (CESR/09-374, CESR/09-188 and CESR/09-212) were disheartening. The UCITS peer review, e.g., revealed low levels of compliance, with only 5 Member States fully applying the guidelines and 20 Member States not applying at least 1. Previous CESR Chairman Wymeersch (in a personal capacity) described the outcomes of the peer review as 'often appalling': *supra* n. 1, at p. 248.

[110] ESMA FAQ, at p. 5.

taken. Where the authority does not comply with the formal opinion, ESMA may address a decision to a financial market participant, as outlined in section 2.6 below.

Article 18 governs ESMA's controversial emergency powers. These powers are triggered where the Council determines that an 'emergency situation'[111] exists, and when exceptional circumstances arise such that coordinated action by national authorities is necessary to respond to adverse developments which threaten the orderly functioning and integrity of markets or financial market stability. ESMA is not, however, granted the wide-ranging powers which this context might suggest. Like the Article 17 enforcement power,[112] it is confined in that ESMA may only adopt individual decisions requiring competent authorities to take the necessary action in accordance with ESMA-scope legislation to address the situation by ensuring that financial market participants and competent authorities comply with the relevant legislation.

Article 19 empowers ESMA to impose decisions on competent authorities in cases of disagreement and represents a considerable step up from CESR's soft mediation powers; ESMA has highlighted the difference between CESR's mediation powers and its new powers to 'settle sectoral disputes'.[113] In the cases specified in the Omnibus Directive,[114] and where disagreement arises between authorities, ESMA may, on its own initiative or at the parties' request, facilitate a mediation process. Where the authorities fail to reach an agreement, ESMA may take a decision requiring them to take specific action or to refrain from action.[115] This regime is constrained: mediation power must be given to ESMA in the relevant delegating measure or the competent authorities must request ESMA's assistance (Article 19); particular voting rules apply to ESMA decision-making (Article 44); and the decision must be proposed by an independent ESMA panel (Article 41).

In principle, it is hard to argue against powers which may, finally, deal with the long-running problem of poor implementation of EU law (Article 17), allow for more coordinated action in a crisis (Article 18) and break through supervisory deadlock (Article 19). It is also the case that these powers relate to exceptional circumstances, are restricted in their terms and contain interinstitutional oversight

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111 In consultation with the Commission, the ESRB and, where appropriate, the ESAs, and following a request by an ESA, the Commission or the ESRB.

112 Although this procedure is not tied to a Commission opinion: Ferran, *supra* n. 1, at p. 52.

113 ESMA FAQ, at p. 6.

114 E.g., under the Market Abuse Directive, Art. 19 will apply where requests for information, to open an inquiry, or for its officials to take part in on-site inspection by a competent authority are refused (Omnibus Directive, Art. 3(6)). Under the Prospectus Directive, it will apply where information requests are refused (Omnibus Directive, Art. 5(11)). Art. 19 applies to a range of situations under MiFID, including with respect to information and inspection requests and the application of precautionary powers (Omnibus Directive, Art. 6(24)).

115 A discrete voting regime applies to this procedure under Art. 44; Arts. 17 and 18 are subject to a simple majority vote.

mechanisms.[116] While Article 18 seems to grant ESMA extensive powers, ESMA's powers are restricted as noted above and Article 18 forms part of a larger super-structure which has been put in place post crisis to prevent and contain crisis. Its practical significance may be limited. Article 17 provides a solution to the long-standing problem of non-compliance by significantly strengthening the reputational dynamics which characterised CESR's peer review activities. Article 19 activates in the context of inter-authority mediation. Mediation between supervisors will often relate to operational questions where there is genuine uncertainty as to the interpretation of a rule or standard, or uncertainty as to supervisory jurisdiction. In these circumstances, ESMA intervention may be efficient and may also allow national competent authorities to achieve practical solutions without reputational damage. There are also a number of braking influences which will apply, in addition to the formal restrictions placed on these powers. The legal uncertainties are considerable, and ESMA may be reluctant to test the robustness of these powers, absent powerful cause (section 3.2). ESMA also has strong incentives to maintain good relations with its constituent members (section 3.1), which may temper overenthusiastic wielding of these powers. Articles 18 and 19 are also subject to the Article 38 fiscal safeguards clause (section 2.9).

Ultimately, despite the prominence they had over the negotiations, these powers may not prove, in practice, to be overly troublesome and may prove useful. Much depends, however, on ESMA's competence, which remains problematic as discussed in section 3. These powers may also have a chilling effect on the exercise of local supervisory discretion, as discussed in the following section.

2.6 Direct supervision: the ESMA Regulation and supervision of market participants

In a 'boundary-stepping'[117] change to the CESR model, ESMA is empowered to address decisions to financial market participants under Articles 17-19, subject to a series of conditions.

Under Article 17, where a competent authority does not comply with the Commission's formal opinion and where timely remedying of the non-compliance is necessary to maintain or restore neutral conditions of competition or ensure the orderly functioning and integrity of the financial system, ESMA may address a decision to a financial market participant, requiring the action necessary to comply with its obligations under EU law; the relevant EU measures must, however, be directly applicable. This regime allows ESMA to bypass the considerable difficulties

[116] ESMA's Art. 17 powers, e.g., reflect the constitutional pre-eminence of the Commission with respect to enforcement. Any ESMA action after the initial recommendation to the non-compliant competent authority is dependent on a Commission 'formal opinion' being issued. The Art. 18 regime depends, e.g., on the declaration of an emergency by the Council.

[117] Ferran, *supra* n. 1, at p. 49.

raised where a competent authority ignores ESMA decisions addressed to it. Although a peer pressure mechanism is available (under Article 17(8), non-compliance with ESMA decisions or Commission opinions must be reported in ESMA's annual report to the institutions), it is unlikely to be effective in a situation where a competent authority is in open defiance of ESMA. Formal enforcement powers lie with the Commission under Article 258 TFEU (against the relevant Member State), but this cumbersome procedure is ill-equipped to deal with fast-moving financial markets and related difficulties arising with the application of EU law.

A similar regime applies under Article 18 where a competent authority does not comply with an Article 18 ESMA decision. The rule to which the ESMA decision relates must be directly applicable, it must be the case that the authority has not applied the rule or has applied it in a manner which appears to be a manifest breach, and urgent remedying must be necessary for orderly market functioning and integrity or financial system stability. Under Article 19, where an authority does not comply with an ESMA mediation decision and thereby fails to ensure that a financial market participant complies with directly applicable ESMA-scope rules, ESMA may adopt an individual decision addressed to a financial market participant, requiring the action necessary to comply with its EU law obligations.

Reflecting these powers, and the legal models established for earlier EU agencies with decision-making powers,[118] the ESMA Regulation establishes a review system to protect third-party interests. Addressees of a decision must be informed of ESMA's intention to adopt a decision and given an opportunity to respond; decisions must also be reasoned (and, absent exceptional circumstances, made public), addressees must be informed of their legal remedies under the Regulation and decisions must be reviewed at appropriate intervals (Article 39). Decisions can be appealed (by addressees and by those directly and individually concerned by the decision) to the independent ESA Board of Appeal (Article 60)[119] and to the Court of Justice under Article 263 TEU (Article 61). Subsequent measures, notably the proposed 2011 Credit Rating Agency (CRA) Regulation,[120] have reinforced third-party rights with respect to specific ESMA powers. The CRA Regulation requires, for example, that ESMA highlight the ability of persons to appeal monetary penalties imposed by ESMA and provide hearings prior to taking enforcement action and/or imposing monetary penalties.

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118 D. Geradin and A. Petit, 'The Development of Agencies at EU and National Levels: Conceptual Analysis and Proposals for Reform' (2004), Jean Monnet Working Paper 01/04, at p. 52.

119 Appeals do not have suspensive effect, although the Board of Appeal may suspend a decision if it considers the circumstances so require.

120 T7_0478/2010 (proposed 2011 CRA Regulation). References to the proposed 2011 CRA Regulation are to this text (political agreement; Parliament first reading, December 2010) rather than the Commission Proposal (COM(2010) 289), unless otherwise indicated.

These eye-catching direct supervisory powers represent a step change in the nature of EU intervention in the financial markets. CESR had taken only very tentative steps in the direction of direct supervision of financial market participants, most notably perhaps with respect to the agreement between CESR members that CESR would approve waivers for MiFID's equity market transparency requirements.[121] Internationally, there are few templates; international standard-setters do, on occasion, speak directly to market participants (the IOSCO Code on Rating Agencies, for example, is directed to the industry) but direct market intervention sits uneasily within the inter-authority, consensus-based model which characterises these bodies.[122]

As with ESMA's powers to address decisions to competent authorities, these powers over financial market participants are activated in unusual circumstances and are generally concerned with escalating circumstances, whether emergency-driven or where relations between competent authorities, and between ESMA and competent authorities, have broken down to a very significant degree. Their practical impact may also be moderated by the legal certainty risks attendant on these powers, ESMA's need to maintain good relations with competent authorities, and resource limitations (section 3 below). The opacity of the powers may also cause difficulties. It is not clear, for example, what follows where a competent authority defies an ESMA Article 18 or 19 decision or Article 17 recommendation, thereby exposing a financial market participant to local enforcement action or retaliation where it complies with a related ESMA decision addressed to it.[123] The Regulation provides that ESMA decisions under Articles 17-19 prevail over previous decisions by competent authorities on the same matter, but a financial market participant may be placed in an invidious position in the admittedly highly unusual situation where its competent authority is in open conflict with ESMA. These uncertainties may, however, lead ESMA to be circumspect in using these powers indiscriminately.

Assuming ESMA's competence (section 3 below), the greatest risks from the Articles 17-19 powers may lie in their potentially chilling effects on market and competent authority challenge, and in their related potential to lead to a general 'hardening' of ESMA's ability to shape supervisory practices. Given the complex dynamics which are likely to characterise relationships between ESMA and its constituent competent authorities (section 3 below), authorities may have strong incentives to support ESMA even if the immediate outcome is a loss of supervisory power. Market actors may accordingly find it politic not to challenge ESMA in the early formative stages. This is all the more likely given ESMA's potential to be almost omnipresent in major supervisory decisions (should it choose to, and where

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[121] *Infra* n. 146.

[122] Brummer, *supra* n. 13, at pp. 281-282.

[123] See also Financial Markets Law Committee, *infra* n. 191, at pp. 14-15, noting that political circumstances may lead to non-compliance by competent authorities with EU law and to competent authority action to incentivise the market participant to act in breach of the ESA decision.

resource constraints and the need to preserve good relations with national competent authorities permit) and the extent to which it will be in receipt of information from competent authorities. In the competition field, from which ESMA's powers over markets actors are drawn, the Commission has suggested that its related powers to intervene in national proceedings under the European Competition Network, which have not been used, have served 'to impose discipline on the system'.[124]

The hardening effect will be all the more intense as ESMA, through a range of information-related powers, may become close to individual market actors. Under the prospectus regime, for example, it will publish lists of approved prospectuses (Omnibus Directive, Article 5(6)), be empowered to inform home competent authorities of the need for a supplementary prospectus (Article 17(8)), and be notified where a host Member State finds that irregularities have occurred under the Prospectus Directive (Article 5(12)). Similarly, under MiFID, ESMA is to maintain a register of authorised investment firms which will record withdrawals of authorisation and sanctions (Omnibus Directive, Articles 6(1) and (3) and 18); a similar ESMA register is also envisaged under the proposed 2011 AIFM Directive (Article 5(5)).

2.7 Direct supervision: the ESMA Regulation and product prohibition

Specific powers are also conferred on ESMA with respect to the prohibition of products and services. Under Article 9(3), ESMA may issue warnings where a financial activity poses a serious threat to its Article 1(5) objectives. ESMA may also temporarily prohibit or restrict certain financial activities that threaten the orderly functioning of financial markets or the stability of the whole or part of the financial system in the Union; this power applies to particular cases specified in EU law and also, if required, in Article 18 emergency situations (Article 9(5)).

Although the Article 9(5) prohibition power was originally conceived as a means of addressing short-selling (section 2.9 below), the potential for activist ESMA intervention is considerable – assuming it is given the requisite powers under the relevant legislative measure. The potential in the retail markets, in particular, is significant given the persistent difficulties generated by product sales in the EU and weaknesses in distribution-related regulation[125] and some enthusiasm, notably from the European Parliament which championed the addition of Article 9 (it confers general retail market powers on ESMA[126]) but also from the Commission,[127] for closer intervention in the retail product markets. But it is doubtful whether ESMA is suitably equipped to prohibit products. Product regulation is notoriously complex,

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124 E.g., House of Commons, Commission Written Evidence, *infra* n. 158.

125 Moloney, *supra* n. 51, ch. 4.

126 ECON Legislative Report, February 2010 (Giegold Report) (PE.438.409 and A7-0169/2010) and Parliament Partial First Reading, July 2010 (T7-0270/2010).

127 *Infra* section 3.2.

with considerable difficulties arising with respect to moral hazard and innovation risks in particular. The EU product market is highly fragmented, with product design typically reflecting long-standing retail market demand patterns in particular markets.[128] It is difficult to see what efficiencies an ESMA power to prohibit would bring, given ESMA's distance from local retail markets and its inexperience as a direct market supervisor. The potential costs are significant in terms of reputational damage to the local supervisor, market uncertainty and the 'chilling' effect which a broadly cast ESMA power to prohibit might generate. Careful coordination with EBA and EIOPA would also be required through the Joint Committee of Supervisors (section 3.1 below), given that retail market products, as the popularity of unit-linked insurance and structured deposits attests, do not sit neatly in particular supervisory silos. The risks may be more potential than real, as it is hard to envisage the circumstances in which the marketing of a retail product would have the systemic implications on which the application of Article 9 is dependent. Nonetheless, the Article 9(5) prohibition power may be a hostage to fortune, particularly given recent evidence that ESMA may take a keen interest in the retail markets (section 3.1 below). Recent statements by ESMA's newly appointed Chairman suggest that ESMA would be willing to take action against high-commission products where negative outcomes for investors are likely.[129]

2.8 Direct supervision: the credit rating agency template

The Articles 17-19 and 9 powers are default and exceptional powers. But with the proposed 2011 CRA Regulation, a direct transfer of more workaday supervisory and enforcement competence from the Member States will take place. There are particular specificities to rating agencies. They represent a small (if influential) section of the financial market, they have extensive cross-border reach (some rating agencies have up to 14 supervisors in their colleges[130]), the impact of ratings extends beyond territorial boundaries and they do not generate material fiscal risks for the Member States, making the transfer of supervisory power a less risky proposition. Nonetheless, the

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[128] E.g., BME Consulting, *The EU Market for Consumer Long-Term Retail Savings Vehicles. Comparative Analysis of Products, Market Structure, Costs, Distribution Systems, and Consumer Savings Patterns* (2007).

[129] N. Tait, 'ESMA Watchdog Prepared to Clash with Brussels,' 2 March 2011, available via: <http://FT.com>, and R. Froynovich, 'ESMA To Be Strongly Independent,' 2 March 2011 (quoting Chairman Maijoor as stating that 'we need to have an eye, and it needs to improve, on serving the interest of the financial consumer and retail investor'), available via: <http://WSJ.com>. Similarly, Keynote Address of ESMA Chairman Steven Maijoor, ISDA AGM, 13 April 2011, noting that ESMA was 'conducting work … to form our future policies and procedures in this important area', available via: <http://www.esma.europa.eu>.

[130] European Commission, *Impact Assessment for the 2010 Credit Rating Proposal* (SEC(2010) 678), at p. 9 (noting that Moody's was expected to have 14 supervisors in its supervisory college under the 2009 Regulation).

transfer of direct supervisory power over rating agencies is a major development as it has required the EU legislative institutions to design an operational model which may support extensive transfers of direct power in the future. The proposed regime for ESMA's supervision of trade repositories under the OTC Derivatives Proposal (section 2.9 below), notably, is modelled on the 2011 Regulation.

The 2011 Regulation is based on a power-sharing arrangement, with power shared between ESMA, the Commission and local competent authorities, although budgetary provision has been made to increase ESMA resources.[131] First, ESMA will have exclusive competence over the registration and supervision of rating agencies (Articles 15 and 16) and to charge registration fees (Article 19); ESMA's central role is underlined by the prohibition placed on it from interfering with the content of ratings or methodologies (Article 23). Member States' 'sectoral competent authorities' will, however, retain responsibility for the supervision of the use of ratings (Article 25a).

Second, ESMA is dependent on the Commission operationally in certain key respects. Its fee-charging powers, for example, will operate within Commission parameters (Article 19), and ESMA must adopt technical standards, which are subject to Commission oversight, concerning the registration process (Article 21).

Third, the competent authorities will be ESMA's operational arms for direct supervision. ESMA may, where it is necessary for the proper performance of a supervisory task, delegate 'specific supervisory tasks' (including investigations and on-site inspections) to local competent authorities; local authorities are required to accede to ESMA's requests, although prior consultation must take place between ESMA and the authority (Article 30). Delegation may not, however, be of such a scale as to dilute ESMA's authority;[132] supervisory responsibilities, including with respect to registration decisions, final assessments, and follow-up decisions concerning infringements, must not be delegated. Similarly, competent authorities – subject to a general cooperation and information exchange obligation (Articles 26 and 27) – must notify ESMA where they are convinced that breaches of the Regulation have been committed in their territory or in another Member State (Article 31). ESMA is to take 'appropriate action' in response, but is not required to follow the authorities' requests. Competent authorities may also request ESMA to examine whether the conditions for withdrawal of registration are met (Article 20(2)). Similarly, competent authorities notifying ESMA under Article 31 may request that ESMA suspend the use of ratings for regulatory purposes in exceptional circumstances.[133] ESMA is not required to follow these requests; under Article 31, it

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131 A €2.5 million increase in ESMA's budget for 2011 was envisaged: ibid., at p. 33.

132 Delegation is envisaged where a supervisory task requires knowledge and experience concerning local conditions which are more easily available at national level (rec. 13).

133 The infringements must be sufficiently serious and persistent to have a significant impact on the protection of investors or the stability of the financial system in the Member State of the competent authority in question.

must take 'appropriate measures' to resolve the issue or inform the authority, setting out its reasons, where it considers the request is not justified and Article 20 requires that full reasons be provided where the registration is not withdrawn. Some care has also been taken to establish ESMA's pre-eminence in on-site inspections (Article 23c): local officials must, for example, 'actively assist' officials and other persons authorised by ESMA, and local enforcement assistance must be made available to ESMA where necessary. A detailed regime also applies to the respective roles of ESMA and the competent authority in on-site inspections (Article 23c). The role of local courts has also been carefully delineated. Where authorisation from a local judicial authority is required to, for example, compel telephone and data traffic, the national court is to check that the ESMA decision is authentic and that any related coercive measures envisaged are not arbitrary or excessive. But while the national court may request an explanation from ESMA as to its grounds for suspecting an infringement of the Regulation and the seriousness of the infringement, the court may not review the necessity of the investigation or require that it be provided with information on ESMA's files. Review of the lawfulness of ESMA's decision is reserved to the Court of Justice (Article 23b). A similar regime applies where enforcement assistance in the context of on-site inspection requires judicial authorisation (Article 23c). While the supervisory model therefore depends on ESMA operating through local supervisors, some care has been taken to protect ESMA's pre-eminence.

ESMA's supervisory powers are extensive, including the power to examine and take copies of any relevant records or material, ask for oral explanations, summon and hear persons, require telephone and data traffic records, and interview persons (Article 23b). The European Parliament's ECON Committee originally conferred ESMA with the power to engage in random sampling of ratings to check rating quality.[134] While during the institutional trilogue negotiations this power was downgraded to a power to examine rating agencies' compliance with their obligation to back-test methodologies (Article 22a), it nonetheless points to ESMA's potential for direct supervisory action. ESMA is also empowered to take a range of enforcement actions directly, including withdrawal of registration, temporary prohibitions on issuing ratings, suspension of the use of ratings for regulatory purposes, and issuance of public notices (Article 24). It is also, as discussed in section 3 below, conferred with fining powers (Article 36a). Although recital 15e avers that the Regulation is not to create a precedent for the imposition of financial sanctions by the ESAs on financial market participants in relation to other activities, the precedent has been established. In a borrowing from the competition sphere,[135] a periodic penalty may also be imposed in order to compel an end to an infringement,

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[134] ECON Legislative Report, November 2010 (Gauzès Report) (PE 448.995 and A7/340-2010).

[135] Council Regulation (EC) No 1/2003, *OJ* 2003 L 1/1.

information to be supplied, submission to an investigation, or submission to an on-site inspection (Article 36b).

Of particular importance is the Regulation's delineation of how enforcement proceedings will be carried out. The ESMA Regulation does not specify how ESMA decisions addressed to market participants are to be enforced in national courts. ESMA has legal personality and enjoys 'the most extensive legal capacity accorded to legal persons under national law' and can be a party to legal proceedings (Article 5). But limited guidance is given on how enforcement might proceed; notably, the European Parliament addition in its July 2010 position on the ESMA Regulation of a recital reference to ESMA decisions creating direct legal effects and being invoked before national courts[136] was removed. On general principles, the Treaty loyalty obligation (Article 4(3) TEU) suggests that national courts should accept ESMA as a party to any subsequent enforcement proceedings, although Treaty difficulties may arise given that the Commission exercises direct enforcement powers under the Treaty as regards breaches of EU law, as the guardian of EU law with respect to the Member States.[137] There is precedent for EU institutions acting as parties in national courts; in a recent UK case,[138] the Commission appeared as defendant to an action concerning the enforcement of a Commission fine related to the competition regime.[139] The 2011 CRA Regulation, however, provides that administrative sanctioning powers can all be directly exercised by ESMA (for example, relevant persons are required to submit to ESMA investigations (Article 23b)), subject to the general review and appeal regime which applies under the ESMA Regulation. It also specifies that fines and periodic penalties are to be enforceable and that enforcement is to be governed by the rules of civil procedure in force in the Member State in the territory of which enforcement is carried out, once the authenticity of the ESMA decision has been verified by the local authority so designated by the Member State (Article 36d). In the case of potential criminal prosecutions, ESMA is to refer matters for prosecution to the relevant national authorities where it finds that there are serious indications of the possible existence of facts liable to constitute criminal offences (Article 23d).

ESMA's powers over rating agencies are extensive, but they are confined to a small sector of the capital markets. The wider significance of the Regulation lies in its establishment of a template for future grants of direct operational power and in the relative speed and ease with which the EU institutions were able to design this template.

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[136] *Supra* n. 126, rec. 19.

[137] The Commission's 2008 report on agencies, e.g., argued that agencies could not be entrusted with powers which had been conferred on the Commission by the Treaty: *The European Agencies – The Way Forward* (2008) (COM(2008) 135).

[138] *Conex Banninger Limited* v. *The European Commission* [2010] EWHC 1878.

[139] I am grateful to Professor Takis Tridimas for discussions on this point.

2.9 Direct supervision: crisis-era measures

2.9.1 *Increasing ESMA's powers*

Rating agency supervision was always envisaged as a part of ESMA's supervisory competences.[140] The extent to which ESMA is being conferred with specific direct supervisory powers under the emerging generation of measures is, however, striking. The Commission's September 2010 Short-Selling Proposal, the proposed AIFM Directive 2011 and the Commission's October 2010 Proposal on OTC Derivatives all, to different degrees, pull ESMA into the supervisory system, limit local competent authorities' powers, and indirectly increase ESMA's influence and harden the wider supervisory environment.

Reflecting the Parliament's addition to the original ESMA Proposal of a power to prohibit products and services,[141] the Short-Selling Proposal, which responds to political and institutional concern regarding the poor coordination of short-selling prohibitions in autumn 2008 and May 2010,[142] confers a range of direct powers on ESMA, albeit subject to an array of conditions and notification requirements.[143] It will be empowered to impose disclosure obligations on natural or legal persons holding net short positions, prohibit or impose conditions on short sales by those persons, limit CDS transactions by those persons, and prevent those persons from entering into transactions relating to a financial instrument or limit the value of transactions that may be entered into; any ESMA decision to this effect prevails over any previous decision under the new regime by the competent authority (Article 24(1)). The change from CESR's power is stark; CESR was able only to disclose, and to a certain extent coordinate, Member State action.[144]

Under the proposed 2011 AIFM Directive, ESMA will be empowered to determine that fund leverage levels pose a significant risk to the stability and integrity of the financial system and to advise competent authorities to take remedial action, including with respect to leverage limits (Article 25). In an 'emergency situation' under ESMA Regulation Article 18, ESMA is also empowered to require competent authorities to take nominated measures, including that restrictions are

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[140] E.g., DLG Report, *supra* n. 6, at p. 53.

[141] Giegold Report, *supra* n. 126, Amendment 76.

[142] E.g., Short-Selling Proposal, *supra* n. 82, at p. 5, and European Securities Committee, Minutes 21 June 2010, noting the 'political priority and urgency of the issue'.

[143] ESMA action must address a threat to the functioning, integrity or stability of the market, cross-border implications must arise, and the competent authority(ies) must have failed to take action (Art. 24(2)). ESMA must also take into account the extent to which the measure will significantly address the threat, improve the ability of competent authorities to monitor the threat, not create a risk of regulatory arbitrage, and not have detrimental effects on the market, including with respect to liquidity and uncertainty. Notification (to competent authorities), consultation (with the ESRB and relevant authorities) and review obligations are also imposed (Art. 24(3)-(9)).

[144] CESR, *Annual Report 2009*, at p. 40.

imposed on non-EU alternative investment fund managers in cases of excessive risk concentrations. Like the short-selling power, this power is confined: a substantial threat to the market must exist, originating from or aggravated by the AIFM, and local competent authorities must either have failed to act or have taken ineffective measures; and the measures must effectively address the relevant threat, not create a risk of regulatory arbitrage and not have a detrimental effect on financial markets, including with respect to liquidity (Article 42a).

The OTC Derivatives Proposal contains significant grants of power to ESMA. Under a model similar to the rating agency model, ESMA will register and supervise trade repositories (Article 51). It will also play a central role in moving all standardised OTC derivatives to CCPs, in line with G20 obligations; once a competent authority has authorised a CCP to clear certain contracts, ESMA will be empowered to decide whether a CCP clearing obligation should apply to all of those contracts in the EU. ESMA will also be empowered (with the ESRB) to decide which contracts should potentially be subject to the CCP clearing requirement (Article 4).[145] While authorisation and supervision responsibilities remain at Member State level, ESMA will participate in the colleges of competent authorities which will coordinate the authorisation and supervision of CCPs (Article 15). In this capacity, it will have the power to request the home Member State to examine a CCP's compliance with the new regime.

A notable feature of the new generation of measures is the extent to which they confer powers on ESMA not only with respect to third-country supervisory coordination arrangements but also in regard to the registration and supervision of third-country actors. The proposed 2011 CRA Regulation will empower ESMA to make endorsement and certification decisions with respect to the use of ratings by third-country rating agencies (Articles 4 and 5). Under the Short-Selling Proposal, ESMA is to coordinate competent authority agreements with third countries (Short-Selling Proposal, Article 32). The OTC Derivatives Proposal confers ESMA with the power to recognise third-country CCPs, subject to conditions, and to recognise third-country trade repositories (Articles 23 and 24).

The MiFID Review has followed this trend. CESR, by voluntary agreement with its members, had acquired a role in reviewing the use of pre-trade transparency waivers by its members.[146] The MiFID Review proposes that this role be formalised. Competent authorities would be required to notify ESMA of their intended use of a pre-trade transparency waiver, ESMA would be required to publish an opinion on its use and, where the authority proposed to use a waiver contrary to an ESMA opinion, it would be required to justify its action publicly.[147]

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[145] The MiFID Review also foresees ESMA's ability to decide whether a derivative should be approved for trading on different categories of organised market: MiFID Review, at p. 13.

[146] CESR *Annual Report 2009*, at p. 52, and CESR/09-324.

[147] MiFID Review, at p. 23. This represents a significant change from the current position. On occasion, CESR has not been able to reach the qualified majority necessary to adopt a common position on waivers: CESR/09-324.

The speed with which ESMA has become a vehicle for institutional interests, particularly the Parliament's and Commission's, in centralising supervision is remarkable.[148] The CESR experience also teaches that the acquisition of supervisory powers can be dynamic. CESR did not have formal supervisory powers. Nonetheless, towards the end of its era, it had begun to press on the boundaries of its formal competences, engaging, for example, in a review of financial disclosures by financial institutions,[149] taking decisions on the waivers issued with respect to transparency requirements under MiFID, and, under a voluntary agreement with leading rating agencies, reviewing their compliance with the IOSCO Code.[150] It may also be the case that ESMA will prove to be a useful device for resolving politically sensitive questions as well. ESMA's role under the proposed AIFM Directive with respect to third-country fund managers, for example, facilitated the adoption of the complex regime which applies to this controversial question.[151]

But ESMA has no experience as an operational supervisor and, as outlined in section 1 above, operational supervision is a difficult business. Direct supervision by ESMA is all the more difficult given the structural and other constraints under which ESMA operates, as discussed in section 3.

2.9.2 *But a fiscal brake in place*

As long as fiscal risk-bearing remains at Member State level, there are significant political limits on the extent to which direct operational power can be conferred on ESMA.

The European Parliament's efforts to confer ESMA with direct supervisory powers over systemically significant cross-border actors, including with respect to a proposed ESMA 'Resolution Unit', foundered over significant ECOFIN concern as to the asymmetric nature of fiscal risk-bearing were ESMA to exercise supervisory powers of this nature.[152] ECOFIN's July 2010 position accordingly downgraded ESMA's role to a monitoring and coordinating one with respect to systemic risk; this model was reflected in the 2010 Regulation (Articles 22-27). Similarly, the Commission's initial suggestion in the ESMA Proposal that ESMA be conferred with 'exclusive supervisory powers' over entities with EU-wide reach or economic

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148 The Commission's FAQ on the proposed 2011 AIFM Directive, e.g., asserted that it 'makes full use of the opportunities afforded by the recent reform of Europe's supervisory architecture': MEMO/10/572, 11 November 2010.

149 CESR/09-821 and CESR/10-1183.

150 E.g., CESR/09-417 (reviewing compliance with the revised 2008 Code).

151 See further, E. Ferran, 'The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis' (2011), available at: <http://ssrn.com/abstract=1762119>.

152 July 2010 Partial Reading, *supra* n. 126, Arts. 6(1)(fc) and 12a(5) and c.

activities with Union-wide reach was removed by ECOFIN in its December 2009 political agreement, which limited this power to rating agencies.[153]

The sensitivity of Member States to bearing the fiscal consequences of ESMA action is reflected in Article 38. It provides that where a Member State considers that an Article 19 mediation decision 'impinges on its fiscal responsibilities', the decision is suspended on notification (within two weeks) by the Member State of ESMA and the Commission. ESMA is to consider the decision within one month; where it maintains the decision, the Council may, by a simple rather than the more usual qualified majority, and within two months of ESMA's review of the decision, decide whether the decision is to be maintained and may terminate it. A similar regime applies to Article 18 'emergency' decisions, albeit with shorter deadlines. The availability of this get-out clause was contested, and the Regulation takes some care to underline its exceptional nature.[154] Nonetheless, it underlines the political restrictions on ESMA's acquisition of direct power.

The same concerns are evident in the proposed 2011 CRA Regulation. Rating agencies represent a small and discrete section of the financial markets and related supervisory decisions are unlikely to generate fiscal risks for the Member States.[155] Nonetheless, a concern to avoid market instability and related fiscal implications can be seen in the new regime. Where ESMA decides to suspend a rating, the rating can be used for ten days after the ESMA decision; where another rating is not available, a three-month period applies and this period may be extended by three months in exceptional circumstances related to the potential for market disruption or financial instability (Article 24(3)). The Short-Selling Proposal is more problematic. ESMA's role with respect to short-selling is largely limited to last resort powers which apply in times of market turbulence. But it is conceivable that ESMA intervention could lead to fiscal risks, particularly were it to intervene in the sovereign debt markets, potentially reducing liquidity and generating volatility and, accordingly, increasing Member States' cost of borrowing. Some sensitivity to fiscal risk is apparent in the Proposal, which requires ESMA to take into account the extent to which its action will not have a detrimental effect on the efficiency of markets, including with respect to liquidity (Article 24(3)). ECOFIN discussions may further limit the scope of this measure.[156]

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[153] ECOFIN Meeting, 2 December 2009: 16571/1-09.

[154] Any abuse of Art. 38, in particular in relation to a decision which does not have a significant or material fiscal impact, is to be prohibited as incompatible with the internal market (Art. 38(5)). Similarly, rec. 50 states that Art. 38 should not be used where the contested decision leads to a reduction of income, following the temporary prohibition of products or activities for consumer protection purposes.

[155] There has been little sign of institutional or Member State dissent. E.g., COM(2009) 252 (setting out the Commission blueprint for supervisory reform) and European Council, 18/19 June 2009, Presidency Conclusions, No. 20.

[156] The UK government is concerned as to the potential for fiscal risks arising from ESMA intervention in the sovereign debt markets: e.g., European Scrutiny Committee, *4th Report, Session 2010-2011*, at pp. 14-15.

The extent to which fiscal risk-bearing is likely to shape ESMA's destiny can be clearly seen in the OTC Derivatives Proposal. There is some strain in the Proposal; the Commission has been careful to confer ESMA with significant influence over CCP supervision, including involvement in the related colleges of competent authorities and with respect to the proposing of BTSs concerning the application of the new regime. Nonetheless, CCP authorisation and supervision will remain at Member State level. Trade repositories, however, as data conduits, do not raise fiscal risks and ESMA has been conferred with exclusive supervisory powers over these actors.

Thus far, there is limited Member State appetite for pan-EU resolution or funding mechanisms as the current debate on bank resolution suggests.[157] Until these are in place, there are limited incentives for Member States to place themselves at risk by further extending ESMA's supervisory powers. Its powers are, however, already significant and political conditions may change.

2.10 **Squeezing local discretion**

ESMA's direct supervisory powers are considerable. Certain of these powers, such as the ESMA Regulation Article 18 power and the proposed powers under the Short-Selling Proposal, have the hue of autumn 2008 and are concerned with crisis-driven intervention. They may be more radical in their design than in their practical ramifications. But they are not to be lightly dismissed. Although the Commission has suggested that ESMA's contested direct decision-making powers over market actors will be 'last resort' powers,[158] as has ESMA,[159] it would be unwise to assume they are paper tigers. This is all the more so given the alacrity with which the institutions have conferred additional supervisory powers on ESMA, even though the 2011 ESMA FAQ notes that any further grant of direct supervisory powers 'is likely to occur in very limited circumstances where the entity is pan-European and where there is a clear added value to EU-level supervision'.[160] Even allowing for the fiscal check, the auguries concerning ESMA's likely trajectory are plentiful. During the final plenary vote on the ESMA Regulation, the European Parliament noted that the ESAs 'will be able to grow as events' require. The extensive ESMA Regulation review clause also contains some significant hostages to fortune (Article 81). And while a case can be made for many of ESMA's powers, ESMA's limited experience

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[157] The Commission's 2010 Communication on Crisis Resolution (*supra* n. 25) is largely concerned with establishing common standards and with national crisis resolution funds, although the Commission's preferred option was for a 'Single EU Fund'.

[158] E.g., House of Commons, Treasury Select Committee, *16th Report 2008*-2009, *The Committee's Opinion on Proposals for European Financial Supervision, 2008-2009*, Commission Written Evidence; ESMA Regulation, recs. 29 and 32.

[159] ESMA FAQ, at p. 9.

[160] Ibid.

in operational supervision, combined with flaws in its institutional model (section 3 below), may generate significant risks.

The more workaday convergence powers and the indirect effects of ESMA's direct supervisory powers have real potential to lead to undue standardisation given the pressure they will place on local operational discretion. Under the ESFS model, local competent authorities remain the default supervisors. ESMA's powers are as delineated in the ESMA Regulation and related measures. And, for the moment at least, local supervisors are pre-eminent. This division of labour, and the preservation of the powers of local authorities, was initially supported by the DLG Report.[161] This duality also reflects the critical relationship between fiscal risk-bearing and supervisory decision-making and accountability, as well as the multiple efficiencies which follow from local supervision. It has been important in reassuring local competent authorities with respect to the new model.[162] As outlined in section 1 above, local discretion over operational supervision is likely to become a very considerable sensitivity given the EU's control over rule and policy-making more generally in the wake of the crisis. But ESMA's powers and its potential to develop dynamically may significantly limit local supervisory discretion in practice with attendant risks to the quality of supervision. ESMA's likely effectiveness as a nascent supervisor therefore falls to be considered.

3. ESMA'S EFFECTIVENESS

3.1 **ESMA's operating model and incentives**

Institutional design for financial market supervision is a complex process, as the construction of the emerging UK regime and the new Dodd-Frank Act structure in the US attest. A significant literature charts the forces which shape institutional design and the difficult choices which arise concerning the (re-)organisation of supervision.[163] The difficulties are all the greater in the EU's internal market with its

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161 *Supra* n. 6, at p. 47, describing the new structure as 'largely decentralised' and proposing that 'national supervisors, who are closest to the markets and institutions they supervise, would continue to carry out day-to-day supervision and preserve the majority of their competences', and that the ESAs would carry out 'a defined number of tasks that are better performed at EU level'.

162 E.g., FSA Chairman Turner, Speech at the City of London Corporation's Annual Reception for the City Office, 6 October 2009, available at: <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/1006_at.shtml>. Similarly, Turner Review, *supra* n. 31, at p. 101, noting 'very strong arguments for keeping the primary responsibility for supervision at Member State level'.

163 E.g., Coffee and Sale, *supra* n. 106; H. Jackson, 'A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the US' (2009), available at: <http://ssrn.com/abstract=1300431>, and E. Ferran, 'The Break Up of the FSA' (2010), available at: <http://ssrn.com/abstract=1690523>.

particular political, institutional and constitutional forces which reflect complex supranational and intergovernmental dynamics. These forces typically operate slowly, gradually shaping institutional structures.[164] Although ESMA's supervisory powers suggest a radical break with the past, incrementalism has left a significant mark. ESMA's supervisory powers are exercised through a structure which reflects long-standing determinative factors, including Member State and competent authority interests, interinstitutional dynamics and (as discussed in section 3.2) constitutional restrictions. This structure also reflects the 'off the shelf' model which EU agency design provides, as well as the network-based model which CESR pioneered. Not all of these influences on ESMA's operating model are likely to lead to good outcomes.

ESMA is an independent authority. But it is formed from its constituent competent authorities and thus continues to reflect CESR's network-based model. The dynamics of the critical relationship between ESMA and the competent authorities are likely to be complex.

On the one hand, ESMA can, *inter alia*, supplant competent authorities under ESMA Regulation Articles 17-19, take action where it deems local action is inadequate (for example, under the Short-Selling Proposal and proposed AIFM Directive), demand justifications of action from competent authorities (for example, as envisaged under the MiFID Review and the Short-Selling Proposal) and shape supervisory practices. On the other hand, ESMA's powers have been carefully delineated and its direct operational powers typically activate in crisis or unusual conditions and are restricted. From the competent authority perspective, the loss of power is real. But authorities may be able to argue for more resources or powers under the cover of ESMA demands. ESMA may also inject a greater degree of realism into the wider political and policy debate with respect to the limitations of supervision in preventing failure.[165] The potential deterrent effects of losing power to ESMA[166] may also drive an enhancement of local supervisory standards.

More specifically, the impact of ESMA's operational model is unclear. ESMA's operating and resource model means that it must rely heavily on the support of its constituent competent authorities. ESMA's budget is small. Its 2011 budget is €17 million and is projected to rise to €24 million by 2013. Its staffing levels are to rise from 70 in 2011 to 120 in 2013.[167] This limited resourcing is reflected in the

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164 M. Thatcher and D. Coen, 'Reshaping European Regulatory Space: An Evolutionary Analysis', 31 *Western European Politics* (2009) p. 806.

165 FSA Chief Executive Sants recently highlighted that 'the [proposed Prudential Regulatory Authority] will not be attempting to pursue a "zero failure" regime. Persuading society that this is an acceptable goal will be a challenge': Sants, *supra* n. 31.

166 These dynamics have been extensively discussed in the US context. E.g., M. Roe, 'Delaware's Competition', 117 *Harvard Law Review* (2003) p. 588.

167 ESMA FAQ, at p. 13. By contrast, and even allowing for a very different range of operational activities, the FSA's budget for 2010-2011 was £458 million.

operating model adopted under the 2011 CRA Regulation which requires ESMA to depend heavily on competent authorities. It is also reflected in ESMA's general working model, which is based on standing committees chaired by senior representatives of national authorities and composed of national experts and ESMA staff.[168] This dependence may lead ESMA to adopt a conciliatory and cooperative approach as it tests its powers. ESMA's working model may also dilute the competence risks to which it is subject, as long as different national practices are carefully filtered. If the FSA example can be relied on more generally, national authorities are adopting an 'open mind' while remaining careful to protect their powers. The FSA has welcomed the ESAs and is 'strongly committed to their success'.[169] One senior FSA official has suggested that 'the less mature approach would be to see the ESAs as somehow needlessly encroaching upon our national responsibilities'.[170] Considerable emphasis has been placed on ensuring that adequate resources are committed to managing the FSA's relationship with the ESAs.[171] But there is a clear concern to emphasise the importance of the competent authorities – 'we believe that the ESAs should be strong, independent organisations and that they will best achieve this by working with their members – the national supervisory authorities'[172] – and nervousness as to the scope of ESMA's powers.[173] Overall, the co-dependence of ESMA and its constituent competent authorities may lead to a nuanced approach to ESMA's extensive powers.

On the other hand, ESMA's budget may increase over time, particularly given likely European Parliament support. During the early 2011 fracas concerning the appointment of the first set of ESA chairpersons (outlined in Part 1), the Parliament's ECON Committee chairperson raised with both ECOFIN and the Commission the necessity for the ESAs to be 'always provided with the necessary budgetary and

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[168] ESMA FAQ, at pp. 13 and 15. A March 2011 speech by FSA Director Sheila Nicoll underlines the importance of the four relevant ESMA task forces in designing the delegated measures to be adopted under the proposed 2011 AIFM Directive: Speech on 'The Alternative Investment Fund Managers Directive – The Road Ahead', Brussels, 17 March 2011, available at: <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/0317_sn.shtml>.

[169] FSA, *The European Supervisory Authorities*, available at: <http://www.fsa.gov.uk/pages/About/What/International/european/esas/index.shtml>.

[170] Nicoll, *supra* n. 55.

[171] FSA, *Business Plan 2011/2012*, at p. 9, and HM Treasury, *supra* n. 54, para. 7.9, warning that the new UK authorities should 'put significant time and effort into ensuring that the UK's voice is heard at the European level and that decisions taken by the new authorities are appropriate'.

[172] FSA, ibid. Similarly, the FSA has described the ESAs as 'member-led' and as complementing, not replacing, national authorities: FSA, *The FSA's International Agenda* (2010), at pp. 5-6.

[173] FSA, *Working towards Effective and Confident European Supervisory Authorities. The FSA's Views on Policy Considerations* (2010), highlighting the FSA's preference for non-binding mediation and suggesting acute concern with respect to ESMA's emergency decision-making powers: at pp. 8 and 11.

human resources in order to fulfil their duties'.[174] Decisive use of its supervisory powers also might be seen as an effective means for establishing pre-eminence over national authorities. ESMA Chairman Maijoor has already signalled some determination to address different supervisory approaches, including with respect to listing.[175] ESMA, despite its lengthy objectives (ESMA Regulation, Article 1), is also an institution in search of a defining mission. Professor Langevoort has written extensively on the importance of the retail investor protection mandate to the SEC.[176] There are some signs that ESMA, like CESR before it[177] but with more operational means at its disposal, may be embracing the retail agenda.[178] This may reflect not only potentially attractive political support[179] and support from the retail-friendly European Parliament, but also a (very) slowly emerging international agenda,[180] which ESMA may wish to lead in order to reinforce its powers concerning international engagement and its international position (discussed further below). A strong retail focus may, however, lead to a generally more interventionist approach.

The interinstitutional dynamics are also complex and it remains to be seen whether a dependent or antagonistic relationship develops, particularly with the Commission (section 3.2); but it does seem clear that ESMA is keen to establish its independence.[181] Market stakeholders have incentives to cooperate with ESMA, but they may face troublesome conflicts at national level (section 2.6 above). The impact of international stakeholders also falls to be considered. ESMA is empowered to develop contacts and enter into administrative arrangements with supervisory authorities, international organisations and administrations of third countries (ESMA

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[174] Letters from ECON Chairperson Bowles to the President-in-Office of the ECOFIN Council and to Commissioner Barnier, both of 1 February 2011, The Hungarian President-in-Office responded that 'the Council has put high ambitions in the ESAs …. it now belongs to both Institutions [the Council and Parliament] to ensure that these ambitions translate into appropriate means each year': Letter to ECON Chairperson Bowles, 2 February 2011. Documents available via the ECON website: <http://www.europarl.europa.eu/activities/committees>.

[175] Froynovich, *supra* n. 129.

[176] E.g., D. Langevoort, 'Re-reading Cady Roberts: The Ideology and Practice of Insider Trading Regulation', 99 *Columbia Law Review* (1999) p. 1319.

[177] Moloney, *supra* n. 51, ch. 8.

[178] Chairman Maijoor is reported to have stressed that ESMA will have a strong consumer focus: Tait, *supra* n. 129.

[179] Although a retail market focus has long been associated with continental supervisors, the UK, traditionally associated with a more market-facing style of regulation, has post-crisis focused closely on the retail markets and has raised the tolerance level for consumer market failures: HM Treasury, *supra* n. 54.

[180] The retail markets have typically been overlooked at international level. A significant change in tone came with the February 2011 Paris G20 Communiqué of Financial Ministers and Central Bank Governors, which called on the OECD, the FSB and other relevant international organisations to develop common principles on consumer protection: available via: <http://www.g20.org/pub_communiques.aspx>, para. 6.

[181] *Supra* n. 129.

Regulation, Article 33).[182] ESMA's influence on the international agenda is likely to be greater if it is regarded as a robust supervisor. Article 33 may therefore provide ESMA with incentives to increase its operational powers. This is all the more likely if international engagement becomes framed, as it was pre-crisis, in terms of liberalisation. The SEC's moves in the direction of a new mutual recognition model were based in part on the 'equivalence' of supervisory regimes.[183] While this project has been sidelined, ESMA has some grounds for assuming that an interventionist approach to supervision, by a single EU authority, may yield dividends internationally.

The adoption of a sectoral model for the ESAs reflects political realities given the potentially troublesome federalist symbol which an integrated Authority might have become. It also reflects practical considerations given the convenient institutional template which the 3L3 committees provided and the sectoral split in the wider legislative regime. But the sectoral model injects the risk of silo-based organisation into ESMA's supervisory activities. ESMA's silo-based model must work in tandem with, and be cognizant of the impact on supervision of, different institutional structures at national level. These include 'twin peaks' functional supervisors, consolidated supervisors (the dominant model), sectoral supervisors and combination models.[184] Related difficulties may arise with its governance model. ESMA's Board of Supervisors is composed of one national supervisor from each Member State, although an alternate may sit on the Board where the subject matter demands different expertise (ESMA Regulation, Article 40(4)). The current restructuring of UK supervision, for example, has considered how ESMA representation should be organised, given the split of financial market supervision between the proposed Prudential Regulatory Authority and the Financial Conduct Authority.[185] The likely shuffling of senior personnel may make it more difficult for ESMA to establish cohesion and trust in its highest decision-making body. This is particularly a risk where ESMA representatives are drawn from new national authorities which may be

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182 These arrangements are not to create legal obligations and are without prejudice to the powers of the Member States and EU institutions.

183 As initially outlined in E. Tafara and R. Peterson, 'A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework', 48 *Harvard Journal of International Law* (2007) p. 31. Similarly, C. Brummer, 'Post-American Securities Regulation', 98 *Columbia Law Review* (2010) p. 327.

184 The emerging UK model, while broadly based on a twin peaks model, looks set to confer prudential supervision over some 18,500 firms on the new Financial Conduct Authority: HM Treasury, *supra* n. 54, at pp. 68-69.

185 Ibid., paras. 7.11-7.14 and 7.20-7.25. It appears that where a prudential matter is raised by ESMA, the (proposed) Prudential Regulatory Authority should be invited as a non-voting observer and its views taken into account by the (proposed) Financial Conduct Authority. Similarly, FSA Chief Executive Sants has noted that 'it is vital … that we achieve effective domestic coordination and cooperation between the regulatory authorities to ensure the UK's views are best represented': Speech on 'Creating the FCA', BBA Conference, 2 March 2011, available at: <http://www.fsa.gov.uk/pages/Library/Communication/Speeces/2011/0302_hs.shtml>.

competing for influence at national level and have incentives to take diverging positions – whether sympathetic or antagonistic to ESMA. Coordination between ESMA, EBA and EIOPA on supervisory matters will also require careful management.[186] Each ESA will seek to establish its position and turf wars cannot be ruled out, although the CESR experience with the '3L3' cooperation initiative is reasonably reassuring.[187] A coordinating Joint Committee of European Supervisory Authorities has been established (Article 54) and the ESAs sit as non-voting observers on each other's Board of Supervisors (Article 40). As noted in Part 1, efforts are also already being made to ensure cross-ESA communication of key decisions;[188] there also seems to be some initial determination to ensure efficient coordination.[189] Unhelpful institutional tensions may, however, lead to a prejudicial 'race to the top' between the ESAs and, accordingly, increase ESMA's incentives to take a grip over EU markets through its supervisory activities.

3.2 ESMA's legal status

ESMA's legal status is the subject of some constructive ambiguity. The ESMA Regulation describes it as a 'Union body with legal personality' (Article 5), but it is termed an Authority. Its structure, however, is closely related to that adopted by the EU 'agencies' which exercise powers delegated from, typically, the Commission.[190] Difficulties with ESMA's legal status have two consequences in particular for its effectiveness as a supervisor. First, doubts as to its constitutional resilience may influence how ESMA approaches supervision. Second, ESMA carries many of the features associated with EU agencies and the related Meroni doctrine. These features and the related implications for legal certainty[191] may hinder ESMA's effectiveness as a supervisor.

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[186] Inter-authority coordination can demand complex coordination models. The emerging regime for the proposed Financial Conduct Authority and Prudential Regulatory Authority will have a variety of elements, including legal coordination duties, MOUs, governance strategies in terms of board representation, and specific coordination mechanisms for specific rule-making and supervisory situations: HM Treasury, *supra* n. 54, at pp. 81-97.

[187] The 2009 CESR Annual Report, e.g., detailed the extensive 3L3 workplan: at pp. 72-80. Recent initiatives include a joint 3L3 report on the lessons learned from the financial crisis in the context of the Commission's Green Paper on Audit (CESR/10-1541).

[188] Including under the proposed 2011 CRA Regulation (Art. 21).

[189] The ESMA FAQ notes its role in fostering supervisory convergence by working closely with the other ESAs: at p. 3.

[190] E.g., E. Chiti, 'An Important Part of the EU's Institutional Machinery: Features, Problems and Perspectives of European Agencies', 46 *Common Market Law Review* (2009) p. 1395.

[191] The UK House of Commons report on the ESAs was of the view that 'it is wrong for an ESA to be given power to override the decision of a national regulator and to direct individual institutions': *supra* n. 156, para. 71. The UK's Financial Law Committee was less trenchant, although concerned as to conformity with the Treaty and with the practical implications with respect to enforcement and whether the ESAs' powers would undermine the ability of national

3.2.1 *ESMA and the Treaty*

The constraint which the Treaty represents may temper ESMA's exercise of its powers. Part 1 considered the doubts as to Article 114 TFEU's (ex Article 95 EC) resilience as a basis for ESMA's quasi-rule-making powers. These doubts are all the greater with respect to operational supervision. The principle that Article 114 does not confer power to regulate the internal market, but supports 'approximating' measures which remove obstacles to free movement or distortions to competition is well established.[192] Plausible arguments can be made that the construction of the internal market requires harmonisation/approximation strategies which contain the risks of that market; a fragmented supervisory system contributed to the retrenchment which occurred across the internal financial market over the crisis.[193] But ESMA's ability to exercise direct operational powers places new demands on Article 114 as a means for managing the pathology, and not simply the benefits, of internal market construction. The ENISA ruling,[194] and its support of EU bodies being constructed under Article 114 in order to support a 'process of harmonisation', has been used in support of ESMA's basis (ESMA Regulation, recital 17). But direct operational intervention on the scale which ESMA brings might be better described as a different form of intervention, associated with but distinct from harmonisation. The ENISA agency, by contrast, is concerned with information sharing and cooperation. The complexity of ESMA's accompanying legal regimes in terms of third-party rights' protection, direct enforcement action, investigations, fiscal protection and shared operational powers points to a new form of intervention. The ENISA ruling also refers to the adoption of 'non-binding supporting and framework measures';[195] but ESMA's direct supervisory powers are binding. ESMA also strains against the Article 5 TEU subsidiarity principle. Is ESMA, distanced from the markets and dependent on good relations with competent authorities, best placed to make operational decisions? But subsidiarity concerns generally have tended to receive somewhat glancing treatment in the post-crisis legislative agenda,[196] leading to some concern from the Commission's Impact Assessment Board.[197]

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authorities to discharge their regulatory functions: Financial Markets Law Committee, Issue 152, *European Financial Supervision: Legal Risks* (2010), at pp. 9-10 and 13-16.

192 E.g. Case C-376 *Germany* v. *European Parliament and Council* [2000] *ECR* I-8419 and Case C-66/04 *UK* v. *Parliament and Council* [2005] *ECR* 1-10553.

193 European Commission, *European Financial Integration Report* (2009) (SEC(2009) 1702).

194 Case C-217/04 *UK* v. *Council and Parliament* (ENISA – European Network and Information Security Agency) [2006] *ECR* I-3771.

195 Ibid, para. 44.

196 E.g., Short-Selling Proposal, *supra* n. 82, at p. 5, and OTC Derivatives Proposal, *supra* n. 85, at pp. 5-6.

197 Subsidiarity concerns have been a recurring feature of the Board's assessment of crisis-era measures. E.g., the Board's assessment of the Proposal to Amend the Deposit Guarantee Directive (Ref. Ares(2010)16390).

The current political and institutional consensus on ESMA's constitutional robustness is holding. This consensus may, as Part 1 argues, fracture as national authorities find their rule-making powers and related ability to build their institutional position and reputational capital constrained by ESMA. ESMA's new supervisory powers may place even greater strain on this consensus as rule-making power has been draining from the Member States to the EU for some time. Competent authorities are also focusing more closely on supervision. The French AMF's 2008 policy on Better Regulation highlights the AMF's new focus on risk evaluation methodologies, new surveillance tools, more specialised personnel and an internal management reorganisation.[198] The 2008 Annual Report by the Italian CONSOB highlights its launching of a strategic planning process to define supervisory policies.[199] The Dutch AFM's efforts include a heightened focus on audits and a 2010 report calling for a fundamental change to how audits were conducted.[200] In the UK, operational supervision has become a major preoccupation following the Supervisory Enhancement Programme over 2008-2009 and the related adoption of Intensive Supervision. ESMA's supervisory activities may become an unwelcome check on supervisory innovation. Supervision is also likely to be an area of considerable sensitivity as it represents the only significant lever which local competent authorities may pull to protect their markets.

ESMA may therefore be sensitive to the potential for a competence challenge and of the related need to manage carefully relationships with national authorities as it tests its supervisory powers. The risk of constitutional challenge may accordingly brake ESMA.

3.2.2 *ESMA as an agency and the Meroni effect*

The seminal Meroni ruling[201] provides that discretionary powers involving a wide margin of discretion which may make possible the execution of economic policy cannot be delegated by an EU institution. Only clearly defined executive powers, subject to strict review in light of objective criteria determined by the delegating authority, may be delegated. The Meroni ruling is strongly associated with the proliferation of agencies over the last twenty years or so and has shaped the structure and powers of EU agencies.[202] It has also shaped ESMA in that many of ESMA's features are designed to respond to the Meroni constraint.[203] But two difficulties in

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[198] AMF, *Better Regulation: Initial Assessment and 2008/2009 Work Agenda* (2008), at p. 16.

[199] CONSOB, *Annual Report 2008*, at pp. 15-16.

[200] AFM, *Report on General Findings Regarding Audit Quality and Quality Control Monitoring* (2010).

[201] Case 9/56 *Meroni* v. *High Authority* [1957-1958] *ECR* 133.

[202] E.g., D. Curtin, 'Holding (Quasi-)Autonomous EU Administrative Actors to Public Account', 13 *European Law Journal* (2007) p. 523, and Geradin and Petit, *supra* n. 118, at pp. 42-43.

[203] See Part 1 with respect to rule-making.

particular arise. First, it is not clear that the agency/Meroni model is an appropriate design for a nascent financial market supervisor. Second, the agency/Meroni model may generate legal certainty risks which prejudice effective supervision.

Turning to the first difficulty, a significant EU administrative law literature examines the impact of Meroni on agency design and the different measures employed to bolster agency legitimacy and accountability in a delegation context.[204] But there are particular difficulties in using the Meroni/delegation model, however sophisticated (and Treaty-driven), as the blueprint for a nascent supervisor. Many Meroni-related agency features are concerned with protecting the Commission's position as principal with respect to the delegation of executive tasks.[205] But the Commission's traditional role in the financial markets area has been to initiate policy, propose legislation and adopt delegated rules. It has little experience with the operational business of supervision. It is also not clear that the Commission is the principal whose interests need to be protected.[206] There is a Commission interest in managing the delegation of executive/implementing powers. But the co-legislators (the Parliament and Council) also have an interest given the norm-setting quality of supervision and enforcement decisions. And although ESMA's supervisory powers are not formally delegated from the Member States (they are not EU institutions from which powers can be delegated), the Member State interest is considerable. Although some EU agencies are conferred with new supervisory powers, supervisory powers in the financial market sphere lay (and still lie) with the Member States,[207] before their being conferred on ESMA. The concepts of institutional delegation and control which have dominated EU agency design do not therefore have the same traction with respect to ESMA and may lead to operational inefficiencies.

The proposed 2011 CRA Regulation places tight restrictions, for example, on how ESMA is to impose monetary penalties (discussed below). It represents an improvement on the original Proposal according to which fining power was reserved to the Commission under a Meroni-based model[208] which was potentially cumber-

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204 E.g., M. Busuioc, 'Accountability, Control and Independence: The Case of European Agencies', 15 *European Law Journal* (2009) p. 599, and R. Dehousse, 'Misfits: EU Law and the Transformation of European Governance', Jean Monnet Working Paper 2/02 (2002), at p. 13.

205 D. Curtin, 'Delegation to EU Non-Majoritarian Agencies and Emerging Practices of Public Accountability', in D. Geradin, R. Muñoz and N. Petit, eds., *Regulation through Agencies in the EU. A New Paradigm of European Governance?* (Cheltenham, Elgar 2005) p. 87, at pp. 93-95.

206 The particular difficulties which ESMA raises aside, the chain of delegation to an agency is generally not easy to identify: Curtin, ibid., at p. 90.

207 Ibid., at p. 94, in the context of the enforcement powers exercised by the (then) proposed Community Fisheries Control Agency and, similarly, Dehousse *supra* n. 204, at p. 13, suggesting that implementation powers move from Member States to agencies, and Geradin and Petit, *supra* n. 118, examining the transfer of powers to agencies in terms of the extraction of power from national authorities (at p. 15).

208 European Commission, *Improving EU Supervision of Credit Rating Agencies – Frequently Asked Questions* (2009) (MEMO/10/230). The Commission's Impact Assessment also argued against direct ESMA fining power given Meroni concerns: *supra* n. 130, at p. 30.

some, inefficient and likely to exacerbate tensions between the Commission and ESMA. But the current detailed model is also troublesome. It limits ESMA's discretion and assumes (given the level of detail in the Regulation) that the co-legislators (Parliament and Council) are better placed to deal with granular operational matters than ESMA. Given the third-party protections provided under the ESMA Regulation (section 2.6 above), there seems little reason to restrict ESMA's operational discretion, apart from the apparent constitutional restrictions, institutional deference to Meroni and related earlier agency precedents; the fining regime under the European Aviation Safety Agency Regulation, for example, reserves fining powers to the Commission.[209] The Commission's related influence over ESMA's rating agency powers (section 2.8 above) is more generally troublesome. Relations between the Commission and ESMA are likely to be tense, given that, as argued in Part 1, the Commission stands to lose from ESMA's acquisition of power. But the formalisation of Commission oversight over ESMA's supervisory powers, reflecting the Meroni model, means that tensions may be fed through to operational decision-making. These tensions may be increased by the European Parliament's championing of ESMA as a supervisor.[210] Unlike the Commission, the Parliament has little to fear from ESMA, particularly given the Parliament's status as a co-legislator with ECOFIN with respect to the legislative measures which confer power on ESMA. Also unlike the Commission, constitutionally the Parliament is not directly concerned with implementation. The recent evidence concerning product prohibition is revealing. Under the MiFID Review, the Commission has proposed that it be empowered to ban products in defined circumstances.[211] The ESMA Regulation, however, contains an enabling clause which empowers ESMA temporarily to prohibit products (section 2.7 above). While the chances of such a Commission power surviving the legislative process are low given the institutional sensitivities and likely Member State hostility, its very articulation by the Commission suggests its concern to limit the transfer of supervisory powers to ESMA.

Second, once the decision was taken to base ESMA's design on agency/Meroni lines, legal certainty risks increased. Under Meroni, discretionary decisions which 'require difficult choices in reconciling various objectives laid down in the Treaty

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209 Regulation (EC) No 216/2008, *OJ* 2008 L79/1, Art. 25.

210 E.g., the Parliament and/or its ECON Committee: added Art. 9 to the ESMA Regulation and called for direct supervisory powers over systemically significant actors (*supra* n. 126); added the ESMA power to undertake random sample tests on the validity of ratings, later diluted to a power to oversee back-testing by rating agencies, to the proposed 2011 CRA Regulation (Gauzès Report, *supra* n. 134); and argued for ESMA (rather than the Commission) to exercise the power to impose fines under the Regulation (I. Wishart, 'MEPS Want to Give More Power to Securities and Markets Authority', *European Voice*, 25 November 2011, available via: <http://www.europeanvoice.com>); and called for additional ESMA information-gathering powers and a hardening of ESMA's power to offer an 'opinion' on a national short-selling decision to the power to make a binding 'decision', ECON Legislative Report, November 2010 (Canfin Report) (PE.454.372).

211 MiFID Review, at pp. 80-81.

amounting to the execution of actual economic policy' cannot be delegated. Most EU agencies do not cause difficulties in this regard as they are designed to support cooperation between national authorities, collate information or provide administrative support or technical expertise to the Commission.[212] A handful of EU agencies at the top of the agency 'hierarchy' are 'decision-making' authorities in that they can impose decisions on third parties. But even these advanced agencies exercise more limited decision-making powers and typically operate within discrete and specialist EU regimes, usually concerned with licensing. The Community Plant Variety Office (CVPO) exercises licensing and right conferral powers.[213] The Office for Harmonisation in the Internal Market (OHIM) administers the Community trade mark regime and exercises related trademark conferral powers.[214] The European Aviation Safety Agency (EASA) exercises powers with respect to safety licensing under the aviation regime.[215] The European Chemicals Agency registers, evaluates and authorises chemicals under the EU's 'REACH' regime.[216] All of these decision-making powers are limited and closely related to particular EU regimes.[217] A step change occurred in 2009 with the Agency for the Cooperation of Energy Regulators,[218] which can take 'individual regulatory decisions' with potentially discretionary and economic implications with respect to cross-border energy infrastructures and exemptions from the energy regime.[219]

ESMA, however, is particularly vulnerable to challenge for breach of the prohibition on delegation of discretionary powers. The sensitive nature of the economic interests potentially at stake is reflected in the Article 38 fiscal safeguard clause as well as in the restrictions which apply to ESMA's direct powers generally. Supervisory decisions can also have a norm-setting effect in financial market regulation; the FSA's 'Treating Customers Fairly' supervisory model came to be regarded as a form of quasi-rule-making by the FSA.[220] It is also not clear that these powers are clearly defined. Challenges may follow given the vagueness of the typical governing terms: when might ESMA safely assume that competition has been distorted, the orderly functioning of the market affected or market stability threatened? The Meroni constraint may therefore lead to a situation in which ESMA's powers are unstable and legal certainty is threatened; the FSA's 2010 position paper on the ESAs is alive to this risk, suggesting that ESMA take care to ensure that any emergency action is not *ultra vires*.[221] The Meroni constraint may

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212 E.g., Chiti, *supra* n. 190, at pp. 1403-1404.
213 Regulation (EC) No 2100/94, *OJ* 1994 L 227/1.
214 Regulation (EC) No 40/94, *OJ* 1994 L 11/1.
215 Regulation (EC) No 216/2008, *OJ* 2008 L 79/1.
216 Regulation (EC) No 1907/2006, *OJ* 2006 L 396/1.
217 Geradin and Petit note the 'clear trans-European component': *supra* n. 118, at p. 39.
218 Regulation (EC) No 713/2009, *OJ* 2009 L 211/1.
219 Arts. 8 and 9.
220 Black, et al., *supra* n. 50.
221 FSA, *supra* n. 173, at p. 11, calling for a panel of expert lawyers to assess action which appears to test the bounds of ESMA's powers.

also lead to the risk of ESMA not exercising powers in cases where it should, fearful of triggering litigation.

The legal certainty risk may diminish in the future as the institutions become more familiar with how to design ESMA powers within the Meroni restriction. The proposed 2011 CRA Regulation, for example, generated some considerable sensitivity to Meroni requirements on the part of certain Member States[222] as well as the Commission,[223] and evolved significantly over the negotiations; the December 2011 political agreement is considerably more sophisticated than the Commission's original Proposal. ESMA's operational discretion is confined by, for example, deadline controls on the registration process (Articles 15-18), the Commission's setting of registration and supervisory fees (Article 19),[224] and requirements governing ESMA's powers to request information (Article 23a), to carry out general investigations (Article 23b) and to take part in or require on-site inspections (Article 23c). Particular requirements apply to ESMA's supervision of back-testing by rating agencies of their methodologies (Article 22a). A detailed Annex III sets out the circumstances in which ESMA can take enforcement action. The nature of enforcement action, including how the seriousness of an infringement is assessed, is specified in detail under Articles 24 and 36a and b. Procedural requirements apply, including the requirement for an independent investigation officer within ESMA to investigate the breach (Article 23d). The fining regime is particularly sensitive to Meroni. The power to impose fines (Article 36a) arises only where the Board of Supervisors finds that a rating agency has, negligently or intentionally (as defined in the Regulation), committed an infringement identified in Annex III. A minimum and maximum fine range applies to each of the Annex III infringements. The Regulation also sets out how ESMA should decide whether fines 'should be at the lower, the middle or the higher' end of these limits.[225] This highly detailed regime will be supported by delegated rules adopted by the Commission with respect to, for example, defence rights, temporal requirements, limitation periods and the collection of fines. A similar design applies to periodic penalties under Article 36b.

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222 Notably the UK: European Scrutiny Committee, *7th Report, Session 2010-2011*, at pp. 70-72, citing the Financial Services Secretary to HM Treasury as noting that 'the legality of delegating discretionary powers to [ESMA] is of vital importance and has been a priority for the Government throughout the negotiations'.

223 The Commission's Impact Assessment Board reports on the proposed 2011 CRA Regulation raised Meroni concerns with respect to the justification for ESMA's supervisory and enforcement powers: Ref. Ares(2010)205437, 21 April 2010 (second report on the revised Impact Assessment) and Ref. Ares(2010)108790, 2 March 2010 (first report on the initial Impact Assessment).

224 The Commission is to adopt a regulation on fees governing the types of fees due, the amount, how they are paid and when costs may be reimbursed to national competent authorities (Art. 19(2)).

225 Annex IV provides, e.g., that if the infringement has been committed repeatedly an additional coefficient of 1.1 must apply to each repetition.

But the price of Meroni compliance may be inefficiencies given the limitations on ESMA's freedom to act. Difficulties also remain. ESMA's supervisory powers under the 2011 CRA Regulation are less heavily constrained than its enforcement powers. Notably, the Commission's Impact Assessment Board was not convinced with the explanation of how the supervisory regime met the Meroni doctrine, and requested a new Impact Assessment.[226] Its review of the revised Impact Assessment repeated this concern.[227]

The Meroni constraint may have led to a 'worst of both worlds' scenario. There are risks to ESMA's supervisory powers. But once ESMA became the institutional vehicle for pan-EU supervision, certainty and effectiveness were required. The Meroni/agency model, however, is ill-suited to financial market supervision.

4. Conclusion

The extent of ESMA's supervisory powers may have pushed ESMA too high up the spectrum from national and towards EU powers, particularly given the likely momentum effects. The ESFS is based on operational supervision remaining at Member State level; the danger of this becoming a matter of form rather than substance is considerable. There are also significant uncertainties as to ESMA's effectiveness as a direct supervisor, which, combined with the current institutional enthusiasm for conferring additional powers on ESMA, is troubling. The Meroni constraint, combined with other structural features, may also lead to less than optimum supervisory decisions by ESMA.

The braver option might have been to limit ESMA's influence on supervision. It might, for example, have been possible to distinguish between ESMA and EBA, which currently share the same set of powers, and to limit ESMA's direct supervisory powers, given that the financial stability concerns which have driven the new structure are, in some respects at least, weaker in the financial market context. But once supervision was placed on the reform agenda, a Pandora's Box opened. It was always going to be a challenge to draw the dividing line between ESMA's powers and those of national competent authorities. Time will tell, but the line may have been drawn too far on the side of further operational centralisation.

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[226] *Supra* n. 223, asking why Meroni issues were only considered with respect to sanctioning and not in regard to other supervisory powers, including registration and inspection: at p. 2.

[227] *Supra* n. 223, p. 2.