Four Predictions about the Future

of EU Securities Regulation

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Abstract

The Lamfalussy Process seeks to reduce barriers to integration in the single market for financial services. This process will not work, however, because of its failure to address two fundamental issues: national protectionism and bureaucratic inertia. The resulting failure will make increased harmonization and some centralization of supervision inevitable. Notwithstanding current opposition to the establishment of a pan-European securities regulator, there will be a European Securities and Exchange Commission (ESEC). The ESEC will be set up, and develop, following the path of least political resistance. Initially at least, the ESEC will focus on corporate disclosure issues, the area where opposition to regulatory harmonization is weakest. It will not have powers to sanction infringements of its rules, as there would be too much resistance to this. The ESEC will, however, be allowed to investigate possible infringements and make its findings and recommendations public. This "soft enforcement" approach will provide incentives for Member States to undertake corrective action and also foster private litigation.

Introduction

Ten years ago one of the authors of this article argued that it was futile to debate the creation of a European Securities and Exchange Commission (ESEC) in the context of a discussion about "current policy and/or practical issues".[1] And it remains true today not only that there is no current policy that such an institution will be founded, but also that there is widespread opposition to the establishment of a pan-European securities regulator. Despite this, the two authors of this article believe that there will be an ESEC, and that it can be predicted what its nature and role will be. This paper analyses these issues.

It is important to stress that the prediction made here that there will be an ESEC does not reflect the authors' views that there should be such an institution. The paper should thus not be taken as advocating the creation of an ESEC. Indeed, the two authors disagree about the benefits of, and need for, such an institution. Both, however, are convinced about its forthcoming arrival.

The paper is composed of four sections. In the first, a summary is provided of the institutional structure established for making and enforcing European Union (EU) securities regulation in the wake of the Lamfalussy report. In section two, it is forecast that this structure will not work, and the reasons why it will fail are outlined. In the third section, it is predicted that an ESEC will come into existence, and some forecasts regarding its nature and role are also made. A brief conclusion is provided in the last section.

1. The Lamfalussy Initiative

The development of a single or integrated market in financial services in the EU has been a long time coming. The Treaty of Rome (1957) envisaged a market in which there would be free movement of capital and services. Since then, an EU enquiry into why an EU-wide securities market has not developed has been commissioned at least once every decade.[2] The most recent was the report prepared by the "Committee of Wise Men" (2001) chaired by Baron Alexandre Lamfalussy, the eponymous Lamfalussy Report. The Committee of Wise Men was asked by the European Union's Economic and Finance Ministers to undertake three broad activities, namely to:

> [1] [a]ssess the current conditions for implementation of the regulation of the securities markets in the European Union; [2] [a]ssess how the mechanism for regulating the securities markets in the European Union can best respond to developments under way on the securities markets, …; and [3] [i]n order to

> eliminate barriers and obstacles, propose as a result scenarios for adapting current practices in order to ensure greater convergence and co-operation in day-to-day implementation and take into account new developments on the markets.[3]

The problems identified by the Committee of Wise Men, and the recommendations they made and the manner in which these have been implemented, are summarized in this section.

1.1. Problems

The Wise Men identified some key problems as being particularly damaging to the construction of an integrated market in the EU.[4] Attention is focused here on the difficulties they identified with the institutional process giving rise to financial services legislation, and also on several generic problems of substance that they noted as being common to many of the Directives governing financial services. The specific difficulties the Wise Men identified with particular areas of financial services legislation are ignored.

The Wise Men observed that the EU legislative system was too slow, as a result of many "blockages" that could and did occur throughout the process, and also stressed that there was insufficient consultation and transparency. They were particularly concerned that there was no mechanism in place to adopt or update Directives in a timely manner, in order to take account of market developments.

The Committee also noted that too many delays occurred in the transposition and implementation of EU Directives by Member States. These delays were seen as arising in part due to the fact that Member States faced a low risk of being sued for infringement given ambiguities in certain Community texts, a lack of Commission resources, and a low number of complaints. In addition, the Wise Men remarked that deficiencies regarding obligations to cooperate, procedures for notification and information-sharing, also affected the day-to-day implementation of Community legislation.

A critical concern of the Wise Men was that many of the Directives in the financial services field failed to distinguish between core principles and the detailed provisions necessary to implement these principles, and were indeed excessively detailed. As a result EU securities regulation had become *inefficient and rigid*, with negative effects on European competitiveness. The Wise Men also observed that many of the texts adopted were very *ambiguous*. This allowed Member States to apply the same provisions in the treatment of the same types of business in a very different manner, creating unnecessary costs and confusion among market participants. It also violated the requirement of the so-called "competitive neutrality" of supervision - meaning that different supervisors in the EU should implement the law in the same manner.

Finally, the Wise Men were of the opinion that the existence of more than forty public regulatory authorities concerned with regulating EU securities markets was far too many for an efficient system. They noted that the creation of FESCO (the Forum of European Securities Commissions) was extremely useful in this respect, but that it faced several drawbacks.[5] These included that it had no official status, that it worked by consensus, and that its recommendations were not binding. Furthermore, the implementation of its decisions in the different Member States was dependent upon the regulatory powers granted internally to each respective regulator, and these differed widely.

1.2. Recommendations and Implementation

The Wise Men believed that urgent action was needed to respond to the problems they had identified, and that in the short term a solution had to be found which was within the confines of existing Treaty and institutional arrangements. A key aim was essentially to provide a mechanism for passing both *primary* and *secondary* legislation, something which was not recognised under the current constitutional structure. The Wise Men therefore proposed a four level approach, the *Lamfalussy Process*, which was subsequently ratified and adopted by all the key EU institutions. They also stressed that for this process to work, both transparency of the process and appropriate consultation with all interested parties, were vital.

Thus, the Stockholm European Council[6] accepted a split between *framework principles* (which were to be called "Level 1") and *implementing measures* (which were to be called "Level 2"). Level 1 was to consist of framework legislative acts, namely Directives or Regulations, to be adopted via the Co-Decision process (by the Council of Ministers[7] and European Parliament). Level 2 would comprise technical implementing measures adopted by the Commission on the basis of powers delegated by Level 1 legislation. The Council resolved that the split between Level 1 and Level 2 should be determined "on a case-by-case basis in a clear and transparent way",[8] and was to be decided by the European Parliament and the Council of Ministers, on the basis of proposals by the Commission.

The Wise Men recommended that Level 2 implementing measures should be used frequently, in order to ensure that technical provisions could be kept up to date with market and supervisory developments. Such amendments would be enacted according to a rule-making procedure, applying a model first established in 1987, the so-called "Comitology" procedure.[9]

Hence, a newly established Committee, the European Securities Committee (ESC), would act in both "advisory" and "regulatory" capacities in the field of securities markets. A representative of the European Commission would chair the ESC, which would be composed of Member State nominees representing the EU economic and finance ministries. In its advisory capacity, the ESC would advise the Commission on securities issues relating to the adoption of proposed Directives or Regulations under the Co-Decision process (Level 1). In its regulatory capacity, the ESC would vote on implementing measures proposed by the Commission (Level 2).

The Commission would also be assisted by a second Committee, CESR. Set-up to replace the pre-existing FESCO, CESR would be composed of senior representatives of national regulatory agencies authorities designated by the Member States. CESR would act as an independent advisory group, particularly, though not exclusively, in the preparation of technical implementing measures (Level 2). In so doing, CESR was required to act in a fully transparent way, consulting market participants, consumers and end-users. The Commission would play a key role giving CESR mandates to act within defined time-limits, would be represented at all meetings of CESR, and would be entitled to participate in its debates.

The key objective of Level 3 was to ensure consistent, timely, common and uniform implementation of Level 1 and 2 acts in Member States, via enhanced cooperation and networking among EU securities regulators. Level 3 would be the responsibility of the Commission, assisted by both the ESC and CESR. CESR, in particular, would play an important role in ensuring more effective co-operation between the Member States' public authorities so as to guarantee more consistent day-to-day implementation of Community legislation.

At level 4, the Commission and the Member States should strengthen the enforcement of Community law.

2. Lamfalussy Won't Work

The first and central prediction of this paper is that:

Prediction 1: The Lamfalussy Process will Not Work.

The Lamfalussy Report, and the subsequent implementation of the recommended institutional changes, has been a major political success.[10] It treads a fine path through the Byzantine complex of power politics between the European Council of Ministers, the European Commission, the European Parliament, Member State national governments and Member State national securities markets regulators. Furthermore, Lamfalussy's insistence on the need for both transparency and appropriate consultation with all interested parties is changing the process of creating EU law significantly for the better. It is also commonly believed, as exemplified by Niemeyer, that the Lamfalussy Process will allow European governments to have "a fast track to implement changes into the regulation of financial services within the EU, thus escaping the deadlock of the normal cumbersome and time-consuming legislative EU-process".[11] Unfortunately, this will not be true. Seven, partly overlapping, reasons why the Lamfalussy Process will not work are identified here.

2.1. Symptoms not Causes

A central flaw in the Lamfalussy Report is that while it correctly identifies the many difficulties with both the regulatory substance and the previous institutional process in EU securities markets regulation, these difficulties are merely symptoms of more fundamental problems. The solutions that the Wise Men proposed, while apparently dealing with these symptoms, do not address their underlying causes, and as a result will not deliver the anticipated benefits.

The two major underlying causes are easy to identify and widely recognised. They are national protectionism and bureaucratic inertia. There are two reasons why the comitology-oriented institutional reforms taken to implement the Lamfalussy Process will do nothing to stop these two forces from operating.

First, the ESC is simply a form of the Council of Ministers writ small. It contains representatives of the same Member State economics and finance ministries that are represented in the relevant Council of Ministers (ECOFIN), all of whom will face exactly the same incentives to protect what they perceive to be in their national interests as they do in ECOFIN. Thus, the same political pressures that gave rise to the deficiencies identified by the Lamfalussy report will continue to operate.

Second, prior to the establishment of the ESC, the European Commission had to commit itself to avoid going against any "predominant" views that might emerge within the Council of Ministers.[12] There can of course be debate about what it takes for a view to become *predominant* in Council. However, it was reported at the time of the insertion of this text, that the pledge was insisted on by Germany, which was afraid that any liberalisation of the system, leading to enhanced competition, could penalise the German financial centre based in Frankfurt.[13] In other words, the commitment of the Commission effectively gives an even greater veto to Member States to stifle pro-competitive proposals of the Commission, than was and remains available via voting procedures in either the Council or the ESC. The Lamfalussy Process thus effectively institutionalizes national protectionism to a greater extent than before, and will therefore not cure the symptoms identified by the Wise Men, such as the slowness of the institutional process for developing EU law, or the ambiguity and excessive detail of Directives.

2.2. Everything Technical will be Political

One key hope of the institutional framework established to implement the Lamfalussy Process is that decisions that are believed technical in nature, namely Level 2 implementation decisions, can be delegated to the ESC in anticipation that by doing so the legislative process can be speeded up. Such a hope will prove to be unfounded. As discussed above, the ESC will simply be a form of Council of Ministers writ small.

To caricature its role, the establishment of the ESC will be seen essentially as being either futile or useless. The existence of the ESC will be futile when taking so-called technical decisions on which there is little political disagreement – as these decisions could have been taken without ESC participation. If, however, there is political disagreement over a particular issue, then the establishment of the ESC will not help resolve such disagreement. On the contrary, exactly the same battles and compromises that so slowed down and diluted the results of the previous legislative structure, will arise in the activities of the ESC. These will continue to give rise to the symptoms as identified by the Wise Men.

2.3. Continuing Battles over Power

The establishment of the ESC, as with the aborted attempt to establish the Securities Committee presaged in the first Investment Services Directive, has proved a focal point for the power struggle between the Commission, the Parliament and the Council of Ministers. The ESC was only finally established after a temporary agreement between the Commission and Parliament over their respective rights and obligations.[14]

Given the ongoing struggle between each of these three institutions, the fragility of the current committee structure (ESC and CESR) will inevitably mean that the three institutions will continue to compete with each other to advance their own interests. In particular, deadlock between the Commission and the Parliament will arise again unless a political resolution is reached at the European Convention.[15]

2.4. A No-Win Situation

The Financial Services Action Plan (FSAP) is a program the Commission adopted in 1999 to improve the single market in financial services.[16] It contains over forty legislative measures to be implemented by 2005 (a deadline set in March 2000 by the Lisbon European Council) that are divided into four broad areas: retail markets; wholesale markets; prudential rules and supervision; and other aspects necessary for an optimal single financial market.

Given the huge legislative burden implied by the FSAP, and the time deadline noted by the Lisbon Council, there is a big incentive to sacrifice quality in the legislation for speed. From the Commission's point of view, it is critically important to keep on passing the legislation. This pressure will significantly increase the risk of the legislative process becoming a box-ticking exercise. Even with the enhanced transparency and consultation arising from the Lamfalussy Process, this is likely to lead to a reduction in the quality of EU legislation. Although the major cause of this fall in the quality of legislation will be the requirements of the FSAP, people will attribute the failure to the Lamfalussy Process and question whether it is working. This will place the Lamfalussy Process into a no-win situation. Either it will succeed in enhancing the quality of legislation, but be accused of unacceptably slowing down the process, or it will fail and be accused of quickly delivering bad law.

2.5. Weak Enforcement

A key problem noted in the Lamfalussy report was that there were excessive delays in the implementation of EU law by Member States, and that these violations of EU law were only rarely challenged. The Committee of Wise Men identified three main reasons why only a small number of infringement cases were brought against Member States: ambiguities in certain Community texts, a lack of Commission resources, and a low number of complaints.

There are two key sources of complaints against Member States: the Commission itself and private sector participants in the markets. The Wise Men did not address, however, why both of these parties are reluctant to lodge complaints. The reasons are simple but powerful. The Commission is reluctant to take Member States to Court for two reasons. First, because doing so would jeopardize the working relationship it has with Member State governments, and second because it is frequently accused by Member State governments of meddling in national affairs beyond its brief. The Commission therefore often seeks some form of political cover before it is willing to complain about individual Member States.

For their part, private sector participants are reluctant to complain about Member States lax enforcement of EU law because they fear retribution, which may take many forms. For example, national regulators may seek to enforce laws on complainants particularly severely, or firms may be excluded from subsequent lucrative government-sponsored deals following a complaint.

The recommendations of the Wise Men will do nothing to reduce the disincentives facing both the Commission and private sector market participants to lodge complaints. As a result, the Lamfalussy Process is unlikely to achieve one of its main aims, namely reducing excessive delays in implementation of EU law.

2.6. Member State Opposition

At first sight it might appear silly to suggest that Member States might want the Lamfalussy Process not to work. After all, they invested a large amount of political time and capital in agreeing to the establishment of the Committee of Wise Men, and then in negotiating the implementation of its recommendations. There is, however, a fundamental tension at the heart of the concept of the single market for financial services, which was reflected in the Lamfalussy report, and which is likely to be a critically important factor inhibiting its success. It is indeed a tension that goes to the heart of the whole EU project.

The aim of the single or integrated market is to make the EU "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured".[17] Three linked strategies have historically been employed to achieve the single market for financial services: the harmonisation between Member States of the essential or minimum standards for the prudential supervision of financial institutions; the mutual recognition, by each Member State, of the competence of the respective national regulatory bodies to insure compliance with these minimum standards; and finally the assignment to the home-country, in those areas which have been harmonized between Member States, of the control and supervision of financial institutions.

The combined notions of minimum harmonization and mutual recognition have two key implications. First, individual Member States have an option to add whatever regulatory structure they believe appropriate, above and beyond the minimum levels that have been harmonized. Second, competition between different Member States' regulatory regimes is legally sanctioned.

To many in the EU, however, the notion of such competition or, alternatively stated regulatory arbitrage, is seen intrinsically as harmful to the rightful authority of important national institutions. Some Member States are also unwilling to countenance the possibility of mutual recognition for fear that their national institutions might lose out in an internationally competitive environment, as indeed some are bound to do.[18] More dangerously in a political context, competition between regulatory regimes is seen as a potential Trojan horse for forcing Anglo-American practices and cultures onto a much more statist and continental European world, notwithstanding current problems with the American version of capitalism.[19] Such an outcome is unacceptable to many Member States, and is why they prefer to focus on the need to develop a *single*, more interventionist, template for supervision.

Those Member States that dislike regulatory arbitrage thus have a strong incentive to ensure that mutual recognition is resisted at all costs, and implicitly therefore that the Lamfalussy Process fails. One possible scenario resulting from such a failure, which was indeed predicted by Baron Lamfalussy himself, is precisely that a pan-European securities regulator should be established. A more immediate result is likely to be further harmonization beyond merely the minimum levels, potentially to the point where Member States do in fact have the same template for supervision throughout Europe.

2.7. Enlargement

The enlargement of the EU will affect Member States' willingness to rely on home country supervision (to the extent they do this already, given their opposition to regulatory arbitrage). While there is an always unspoken, but widely recognised, hierarchy of ability amongst Member States' securities market regulators, there is a much more outspoken concern among the EU national regulators, and more importantly among Member State governments, that the regulators of those countries seeking accession to the EU may, bluntly, not be capable enough.

This concern is bound to stress further the existing willingness of Member States to accept the notion of home country control. As a first step, it will result in a *de facto* dilution of the principle of home country control for the accession countries. This in turn, will make it politically palatable for Member States to object to mutual recognition across the board, and in particular even for other established Member states. The predictable end result will be that the Lamfalussy Process, which aims to facilitate mutual recognition, will become irrelevant.

2.8. Summing-up the Failures

The comitology-oriented institutional reforms adopted following the Lamfalussy Report will neither reduce delays in regulatory implementation, nor improve substantive flexibility and certainty of EU financial services legislation. As confirmed by recent incidents, national protectionism and bureaucratic inertia will not be constrained, institutional power struggles will continue as previously, and enforcement of EU law will remain weak.[20] In addition, the Lamfalussy reforms will be blamed even for those regulatory deficiencies that are not directly related to them. In particular, market participants will consider the Lamfalussy Process to be the cause of one possible outcome of the Financial Services Action Plan, namely the quick delivery of bad law, even though such delays do not arise as a direct result of the Lamfalussy recommendations. Similarly, some Member states will blame the Lamfalussy Process for any form of regulatory arbitrage they find unpalatable, even though they originally agreed that it should expressly aim at facilitating mutual recognition – and, thus, regulatory competition. Finally, the practical realities of European enlargement will make the Lamfalussy Process irrelevant, as regulatory strategies will aim at maximum harmonisation and centralisation, rather than minimum harmonisation and mutual recognition.[21]

3. A New Force – The Path of Least Resistance

Predicting the failure of the Lamfalussy Process to achieve its intended goals is easier than knowing what will come after it. Nevertheless, the second prediction of this paper is that:

Prediction 2: There will be a European Securities and Exchange Commission (ESEC).

Three possible futures are believed most likely subsequent to the failure of the Lamfalussy institutional framework to deliver its desired results. The most improbable of these possible worlds is that a political consensus will grow about two conclusions: 1) the causes of the problems identified by the Wise Men are indeed national protectionism and bureaucratic inertia; and 2) the best response to these problems is to seek to deliver in reality what many of the Directives propose in law, namely to achieve an EU in which mutual recognition works. The pre-condition for allowing mutual recognition to work will be that Member states recognize that regulatory competition (or equivalently regulatory arbitrage) has advantages and is acceptable. They must see it as the appropriate strategy for best enhancing the capital markets in Europe, for encouraging, as it has elsewhere, a “race to the top” and not “to the bottom”, and for eliminating regulatory inefficiencies and bureaucratic inertia.

To describe such an outcome is to illustrate its improbability. It is extremely unlikely to happen simply because of the historical antipathy in many EU Member States towards such an approach, as noted above. Whatever the perceived merits and evidence supporting a policy of full mutual recognition and regulatory competition, some Member States see it as undermining too much national sovereignty. They understand clearly that the likely outcome of such a policy would also be an even greater concentration of financial services in fewer Member States than currently exists, with the attendant likelihood that some national institutions will lose out in a more internationally competitive environment. Regulatory competition is also seen as a potential vector for surreptitiously forcing Anglo-American practices onto continental Europe. Whatever economic efficiencies might arise in an environment with true regulatory competition, therefore, are outweighed by political considerations in the view of many Member States.

The second possible future following the failure of the Lamfalussy Process is that nothing will be done. The *status quo* will continue, and the four Levels of regulatory activity, together with the two new Committees (ESC and CESR) will carry on operating. All the problems identified with the process will therefore also continue: Directives will be ambiguous and excessively detailed, their implementation will be slow and uneven across the EU, the various passports prescribed in the relevant Directives will not operate in reality, and protectionism will continue to prosper. While this is a highly conceivable outcome initially, it is believed here that it will not last for two main reasons.

First, an inter-institutional monitoring system will conduct regular assessments of how the Lamfalussy Process is working and most importantly, a full review of the process will be undertaken in 2004.[22] These reviews will find that the Process has not worked, and are therefore likely to recommend change. Second, the political consensus that led to the initiation and implementation of the Lamfalussy process had a broad base. The need for reforms that generated the Lamfalussy Process will not disappear with its failure, and there will be widespread calls to find alternative solutions. The *status quo* will therefore not be sustainable.

The third possible future following the failure of the Lamfalussy Process is that the regulatory process will become centralised, and some form of pan-European securities regulator or ESEC will be established. In its final report, the Committee of Wise Men indicated that there were three reasons for not considering the establishment of a single regulatory agency:

> First, the basic harmonized rules necessary for the appropriate functioning of an integrated market are not yet in place. Second, speedy action is needed to correct the identified shortcomings of the present regulatory framework; and speed requires reforms carried out within the confines of the present Treaty. Third, some time will be needed to ascertain whether any such reforms deliver, or fail to deliver, results.[23]

The Wise Men did, however, critically temper this assessment with the important caveat that an ESEC was not needed "at this [sic] stage of the development of the EU's securities markets", implying that one might be appropriate at a later stage. The Wise Men, and Baron Lamfalussy himself subsequently, both explicitly noted that the proposed structure was not intended to be anything other than a temporary solution to an institutional problem of a particular time. They also predicted that a pan-European securities regulator might have to be established should the structure they recommended fail to achieve the desired results.[24]

The idea of an ESEC is not new: Hopt argued in 1976 that such an institution should be considered and Walter recently stated that it would be unavoidable if Europe is serious about having a single financial market.[25] The ESEC is likely to differ from the current EU institutional structure in three important ways. First, neither representatives of Member State governments nor the European Commission will have direct control over the ESEC, and in that sense it will be independent and autonomous. Second, it will have decision-making powers going beyond those currently obtained by either the ESC or CESR. Finally, the ESEC will have some enforcement powers.

The establishment of the ESEC will not require a Treaty change.[26] Its role could initially be relatively limited, with further developments subject to a step-by-step approach. The most likely way to effect the transition from the Lamfalussy structure towards an ESEC, will be via the ESC or CESR obtaining progressively more powers. Indeed, CESR is already the front-runner to take on a transition role to form the basis for the ESEC for several reasons. CESR is independent of Member States, in the sense that representatives on CESR are mostly not part of their respective governments. The members of CESR have an expertise in regulating securities markets, whereas the representatives of the ESC are highly placed bureaucrats in Member States' economics or finance ministries. The potential importance of CESR as a proto-ESEC has not been unappreciated by the French government, as is evident in two ways.[27] The first is the French government's successful lobbying program to have CESR located in Paris, and the second is the placement of one of their most able administrators as the first Secretary General of CESR.

If it is thought that the establishment of an ESEC did require a Treaty change, this should not be viewed as an insurmountable obstacle. The Treaty is likely to be amended in the coming years, and such revisions could incorporate relevant provisions about the ESEC. It is obvious, but still worth noting, that all three of the main institutions of the EU – the Council of Ministers, the Commission, and the Parliament – will stress that any decision about a pan-European securities regulator must be made in full respect of the Treaty provisions and the prerogatives of their relative institutions. Such concerns did not, however, stop the establishment of either the ESC, CESR, or indeed the European Central Bank (ECB).

The one central lesson to be learnt from the activities of the Wise Men is the simple one that politics matters. The success of the Wise Men in having their institutional process accepted and implemented was grounded in the fact that they sought and obtained wide political acceptance for their analysis and recommendations. The creation of the ESEC will similarly only be possible if it too obtains wide political support. However, universal support throughout the EU will not be necessary for its creation.

The need to obtain wide political support has an important implication for what the nature of the ESEC will be like. To be created in the first place, the ESEC will have to follow the path of least political resistance. Initially, this rules out setting up the European equivalent of the US SEC, with its wide remit and broad range of investigative and enforcement powers. In order to be politically palatable, the ESEC will have much more limited substantive and enforcement powers, so that a range of concerned institutions, including national regulators, do not feel that what they perceive as their primary prerogatives are overly threatened. On the other hand, the ESEC will also need to be more than simply an office with a nameplate on its door, if it is to satisfy the demand to be a centralised and credible regulatory force.

The idea of an ESEC will have strong support from those Member States opposed to mutual recognition, concerned about the impact of the EU's enlargement on the quality of home country supervision, and imbued with the philosophy that the correct approach to deliver a *single* market is precisely to have a *single* regulator. It will also gain political support from the many countries which wish to constrain the success of the UK as the dominant provider of financial services in the EU, by providing a centralised regulator able to limit competition between markets, thereby ensuring a future for their national financial centres. France has already raised the possibility of creating an ESEC several times.

In short, the combination of the failure of the Lamfalussy Process on the one hand, and the unacceptability of strengthening mutual recognition and regulatory competition in the EU on the other hand, will both reduce objections to, and generate sufficient political support for, the establishment of the ESEC. There will be no apparent alternative.

Prediction 3: The ESEC will Focus on Corporate Disclosure Issues

Strong resistance to giving the ESEC autonomous rule-making powers can be expected in some areas. For example, it is most unlikely that political agreement can be reached about giving the ESEC a say regarding prudential matters. Prudential supervision aims at preventing the insolvency of one financial intermediary from spreading to others in a spillover effect that could ultimately endanger the financial system as a whole. The current “prudential” supervisors in Member States can be expected to oppose the transfer of such a role to the ESEC – among other reasons, because it would be unable to pump liquidity into financial markets should its rules fail to prevent an insolvency from threatening the financial system as a whole. The ECB is also likely to object to the ESEC obtaining prudential powers, as this might affect the ECB’s potential prerogative, namely the supervision of the major EU banks.[28] An indication of the sensitivity of issues related to prudential supervision is that in its mandate to the Wise Men to examine the regulation of securities markets in the EU, the European Council specifically stated that the Committee should not deal with prudential supervision.

Similarly, it is most unlikely that political agreement can be reached about giving the ESEC a say regarding market regulation or supervision. National market regulators and supervisors can be expected to oppose strongly any transfer of powers to the ESEC because that would be a major threat to their own survival.

Corporate disclosure is the area where political resistance to the granting of rule-making powers to the ESEC is likely to be the lowest. Despite academic debate about the efficiency of centralised and/or mandatory disclosure requirements,[29] jurisdictions around the world have been requiring issuers to submit to increasingly demanding transparency rules and to do so through public authorities.[30] Moreover, past efforts to harmonize EU corporate disclosure rules have faced more limited opposition than in other areas. For example, EU directives have been adopted on issues ranging from accounting standards, to transparency of prospectuses, to ongoing disclosure of material changes in companies.

To be sure, there is also resistance to EU regulation of corporate disclosure. For example, Member State opposition to rules on financial instruments threatens to delay EU reforms aiming at increasing the harmonisation of EU accounting standards.[31] However, while such resistance is part of the trend that will make the Lamfalussy Process fail, its protectionist and bureaucratic roots are not as deep as in other regulatory areas, as is shown by its delaying rather than blocking effects. Moreover, recent accounting and auditing scandals are likely to weaken opposition to the centralized regulation of corporate disclosure.

In short, assuming that there will be an ESEC, but that it will only prove palatable if it is established along the path of least political resistance, it is reasonable to predict that the ESEC will focus, at least initially, on corporate disclosure issues.

Prediction 4: The ESEC Will Obtain "Soft" Enforcement Powers

For political reasons, Member States will retain significant enforcement powers. Decentralization of enforcement, however, is only sustainable if it does not lead to major compliance deficiencies.[32] There are good reasons to believe that Member States will not be able to guarantee effective corporate disclosure by EU issuers. For example, EU accounting reforms aim at requiring around 7000 EU companies traded on EU regulated markets to follow International Accounting Standards (IAS) by 2005.[33] Taking into account the fact that only 10% of the targeted companies currently comply with IAS, and the comparative opacity of most Member States' accounting standards, it is hard to believe that Member States will be able to guarantee the appropriate transparency of financial statements.[34] The controversies marring EU attempts to strengthen mandatory disclosure requirements for companies that go public are another sign that Member State implementation of disclosure provisions will be rather ineffective.[35]

These deficiencies will make the allocation of enforcement powers to the ESEC unavoidable. Thus, the question is not whether the ESEC will get enforcement powers vis-à-vis issuers, but what kind of powers it will get. The prediction here is that, at least initially, the ESEC will obtain "soft" enforcement powers.

"Soft" powers are not equivalent to weak powers. The ESEC enforcement powers will merely be "soft" because it will get investigation rather than sanction powers.[36] Hence, we predict that the ESEC will be allowed to gather data about infringements of corporate disclosure rules. The ESEC will also be allowed to make its findings and recommendations public.

The ESEC will thus have more than the peer-review capability suggested by the Lamfalussy report but less than the sanction and public action powers of the US SEC. The combination of fact finding and publicity powers will, however, make the ESEC a powerful force for both political and litigation reasons.

As far as Member State law-making is concerned, one can expect media scrutiny and political attention to follow the disclosure of ESEC data showing deficiencies in the implementation of EU law. This in turn is bound to improve a rather mixed implementation record, not least because two of the most likely proponents of the establishment of the ESEC, namely France and Italy, are at the bottom of implementation rankings.

ESEC intervention is also likely to improve issuer compliance with corporate disclosure requirements by increasing the threat of litigation for two reasons. First, if the ESEC makes public that named issuers are not cooperating with it, for example by refusing to provide data or explain compliance deficiencies, this will increase the likelihood that national regulators undertake appropriate enforcement procedures – and thus increase compliance levels. Second, and more importantly, ESEC intervention should foster private enforcement.[37] Very generally, ESEC intervention will make financial statements, periodic disclosure and ongoing information less opaque, thus making it more difficult to issue misleading statements, or to hide managerial mistakes and blatant discrepancies between compensation and performance. Given increased competitive pressures, which aggravate the consequences of mistakes, and reduced investor tolerance towards managers who fail to deliver, this is likely both to increase investor's willingness to sue, as well as courts' sympathy for their complaints.

Moreover, ESEC rule-making will reduce difficulties in establishing standing to sue managers, as it aims directly to protect investors. This should prove especially important in Member States where many disclosure rules are part of corporate laws that do not give individual shareholders the right to bring derivative actions.[38]

Finally, "soft" enforcement by the ESEC should provide *prima facie* evidence of the violation of corporate disclosure provisions. It is difficult to predict the extent to which ESEC fact-findings will bind courts, as this will depend upon the procedure applicable to ESEC investigations and appeals possibilities. But even if evidence gathering had to be done anew by private plaintiffs, public statements by the ESEC about issuer compliance deficiency is likely to reduce investors' litigation risks (given that "there is a smoking gun") as well as the burden of proof (because the issuer will have failed to provide a credible explanation about why it has failed to comply).

To be sure, individual investors may still refrain from suing. There are, however, indications that on-going EU harmonization will improve the acceptance and profitability of collective action procedures. First, major law firms will be in a better position to assemble a critical mass of claimants - including institutional investors eager to minimize financial or reputational losses. Second, judges may become more willing to impose stiff sanctions on publicly held firms that grossly violate EU law. Third, European class actions and contingent fees – a main cause of the difference between US and EU private enforcement levels – are becoming palatable. For example, Germany is considering the introduction of some sort of class actions, and other EU jurisdictions may follow the same path.[39]

4. Conclusion

This paper examines the future of securities markets legislation and regulation in the EU. Four core predictions are made:

1. The Lamfalussy Process will not work.

2. There will be a European Securities and Exchange Commission (ESEC).

3. The ESEC will focus initially on corporate disclosure issues.

4. The ESEC will obtain "soft" enforcement powers.

These predictions do not reflect the authors' views as to what should happen - only what they believe will happen.

Notes

[1] See Proceedings of the 1993 Vitznau Conference, in Buxbaum et al. (1996).

[2] These include the Segré Report (Commission 1966), the Schmidt Report (Commission 1977), the Wymeersch Reports I-III (Commission 1978-80) and the Cecchini Report (Commission 1988).

[3] See Terms of Reference quoted on in Committee of Wise Men (2000) at 30.

[4] See Committee of Wise Men (2001).

[5] FESCO is now replaced by the Committee of European Securities Regulators (CESR) – see infra 1.2.

[6] The European Council comprises the head of states or government of the Member states. Its decisions define the general political guidelines of the European Union.

[7] The Council of Ministers, or Council of the European Union, comprises the Member State's Ministers and its composition varies depending upon the topics on the agenda (e.g. Economics and Finance Ministers for financial matters). The Council of Ministers is the European Union's legislative body, whereas it often acts in co-decision with the European Parliament.

[8] European Council (2001).

[9] See Council Decision 99/468/EC, O.J. 1999 L 184/23; Council Decision 87/373/EEC, O.J. 1987 L 197/33; Lenaerts and Verhoeven (2000).

[10] See e.g. Commission Decision of 6 June 2001 establishing the European Securities Committee, O.J. 2001 L 191/45; Commission Decision of 6 June 2001 establishing the Committee of European Securities Regulators, O.J. 2001 L 191/43.

[11] Niemeyer (2001) at 10.

[12] European Council (2001), Resolution 6 (in order to find a balanced solution for those cases of implementing measures in the field of securities markets acknowledged in the light of discussions to be particularly sensitive).

[13] See Robin Oakley, *European Leaders facing Tough Challenges*. March 23, 2001 (available at www.cnn.com).

[14] See Ferrarini (2002) at 259.

[15] The European Convention was set-up in 2002 and aims at proposing a new framework and structure for the European Union (see http://www.european-convention.eu.int).

[16] Commission (1999).

[17] Article 8a, Treaty of Rome (as amended).

[18] See Hertig (2001).

[19] See also Peter Norman and Francesco Guerrera, *How Politics, Protectionism and Cultural Clashes Could Dash Europe's Dreams of a Single Financial Market*, FINANCIAL TIMES, December 4, 2002 at 11.

[20] See Norman and Guerrera, supra note 19; Lex Column, *The Prodi Plot*, FINANCIAL TIMES,

November 19, 2002 at 14; Paul Hofheinz, *A Capital Idea*, WALL STREET JOURNAL (European ed.), October 18-20, 2002 at R8.

[21] For a similar, but more generalized conclusion, see Moloney (2002) (harmonization will increase because of a basic change in regulatory philosophy).

[22] European Council (2001), Resolution 7.

[23] Committee of Wise Men (2001) at 95.

[24] Committee of Wise Men (2001) at 95 ("…if the approach did not appear to have any prospect of success, it might be appropriate to consider a Treaty change, including the creation of a single EU regulatory authority for financial services generally in the Community").

[25] See Hopt (1976) and Walter (2001).

[26] See also O'Keeffe and Carey (2002).

[27] France has been one of the supporters of the establishment of a pan-European securities regulator during the debate about the implementation of the Lamfalussy recommendations: see Peter Norman and Ed Crook, *France Forced to Scale Back European Super-Regulator*, FINANCIAL TIMES, July 11, 2000.

[28] See the simplified procedure provided by Article 105(6) of the Maastricht Treaty to entrust the ECB with such powers; Danthine et al. (1999).

[29] Compare e.g. Romano (2002) and Fox (2001).

[30] See Hertig, Kraakman and Rock (forthcoming 2003).

[31] Andrew Oarker, *EU accounts deadline passes*, FINANCIAL TIMES, January 2, 2003.

[32] See also Bebchuk and Roe (1999).

[33] See Regulation 1606/2002 on the application of international accounting standards, O.J. 2002 L 243/1.

[34] See Robert Bruce, *Europe's Companies are Brought to Account*, FINANCIAL TIMES, July 15, 2002 at 17 (also listing the number of inconsistencies between national and IAS rules).

[35] See Commission (2001/2002).

[36] See also La Porta et al. (2002) (pointing out the importance of investigative powers of securities regulators).

[37] Compare La Porta et al. (1997) and (1998) (private enforcement is not very effective in the EU).

[38] See e.g. Baums (1996).

[39] See Hopt (1999), at 58-59.

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