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Financial Reform in the European Union: Establishing the Common Technical Rulebook

Derek Takehara

Pacific McGeorge School of Law

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Financial Reform in the European Union: Establishing the Common Technical Rulebook

Derek Takehara*

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* J.D. Candidate, University of the Pacific, McGeorge School of Law, to be conferred May 2013; B.A., Business Economics, University of California, Santa Barbara, 2007. I would like to thank Professor Michael Malloy for his sincere enthusiasm and substantive guidance. Also, thank you to my family for their ever-present encouragement, love, and support.

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I. INTRODUCTION

Since the inception of the global financial crisis in 2008,¹ financial regulators throughout the world have focused on ways to repair the economic damage and improve regulatory frameworks to prevent and detect future crises.² Fundamentally, the crisis was the result of an increasingly global financial system that became plagued by growing macroeconomic imbalances.³ These imbalances synthesized an unsustainable credit boom and a pattern of overpriced assets, which eventually impaired banks' ability and willingness to extend credit, and ignited a free-fall in asset valuations.⁴ Beyond pure economics, institutional weaknesses in corporate governance and failed regulatory schemes have also been cited as significant contributors to the global financial crisis.⁵

To address the immediate effects of the crisis, regulators inoculated their respective economies with varied monetary responses.⁶ The most notable and controversial of these rapid-fire reactions were the bailouts of financial institutions, particularly those that occurred in the United States.⁷ Similar bailouts and responsive measures occurred in Europe and have resulted in passionate debates about whether further injections should be used to cure the ongoing Eurozone debt crisis.⁸

Looking through a long-term lens, regulators also took action to develop ways to prevent future crises. In the United States, the Dodd-Frank Act was

1. The financial crisis was the culmination of economic and regulatory failures which developed over time, but most commentators pinpointed 2008 as the point in which its detrimental effects were felt on a large global scale. See Ioannis Glinavos, *Regulation and the Role of Law in Economic Crisis*, 21 EUR. BUS. L. REV. 539, 551 (2010); see also Randal D. Guynn, *The Global Financial Crisis and Proposed Regulatory Reform*, 2010 B.Y.U. L. REV. 421, 421 (2010); see also FIN. SERVICES AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS (2009), available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

2. Nicolas Véron, *Financial Reform After the Crisis: An Early Assessment* (Peterson Inst. for Int'l Econ., Working Paper No. 12-2, 2012), available at <http://www.iie.com/publications/wp/wp12-2.pdf>; Governor Daniel K. Tarullo, Speech at the Council on Foreign Relations C. Peter McColough Series on International Economics: Regulatory Reform Since the Financial Crisis (May 2, 2012).

3. FIN. SERVICES AUTH., *supra* note 1, at 28.

4. *Id.*

5. Kern Alexander, *Reforming European Financial Supervision and the Role of EU Institutions*, AMICUS CURIAE, Summer 2010, available at http://sas-space.sas.ac.uk/2787/1/Amicus82_KernAlexander.pdf.

6. *Credit Crisis: Bailout Plan (TARP)*, N.Y. TIMES, http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_crisis/bailout_plan/index.html (last updated Dec. 7, 2010); Guynn, *supra* note 1, at 434-60.

7. *Credit Crisis*, *supra* note 6; Guynn, *supra* note 1, at 434-51.

8. As of the date this Comment is being written, the Eurozone debt crisis remains a political and economic priority in Europe. See Michael P. Malloy, *Zone Defence: The Euro Zone and the Crisis in Financial Services Markets*, in FINANCIAL CRISIS, GLOBALISATION AND REGULATORY REFORM 9 (David A. Frenkel & Carsten Gerner-Beuerle eds., 2012); see also *Europe Begins Working on Plan B for the Euro*, SPIEGEL ONLINE (Oct. 7, 2012), <http://www.spiegel.de/international/europe/0,1518,790543,00.html>; see also *Greece Likely to Get Its Bailout*, WASH. POST (Feb. 18, 2012), http://www.washingtonpost.com/business/economy/greece-likely-to-get-its-bailout/2012/02/17/gIQAxqjeMR_story.html.

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signed into law on July 21, 2010.⁹ Other prominent nations, including the United Kingdom, took on equally aggressive roles in reconsidering their regulatory systems.¹⁰ Indeed, the entire European Union has undergone significant financial reform,¹¹ which serves as the focus of this Comment.

While most commentators accept that the regulatory systems of leading economic nations failed to prevent the crisis, the approaches to avoiding future crises have been mixed.¹² The variations in these reforms can be credited to contrasting assumptions about the specific causes of the crisis and divergent views of what objectives should be accomplished.¹³ Thus far, most of the post-crisis focus has been on ensuring the health of financial institutions and protecting consumers, but regulators must be wary of any changes their new regulatory frameworks will have on the competitiveness of the financial markets.¹⁴ This is especially true as globalization increases and the world's economies continue to collide.

The regulatory overhaul in the European Union provides an illustrative case study of post-crisis financial reform. The European Union's experience is unique because of its tiered structure, diverse national membership, and global economic importance.¹⁵ Together, its twenty-seven Member States comprise the world's largest economy.¹⁶ Thus, the success of the European financial reforms is vital to the goal of global economic recovery¹⁷ and will provide a prominent example of financial regulatory practices for the future.

Since the inception of the crisis, the European Union has created two new regulatory bodies: the European Systemic Risk Board ("ESRB") and the European System of Financial Supervisors ("ESFS").¹⁸ The ESRB is responsible for macro-prudential oversight of the European Union, while the ESFS is responsible for micro-prudential oversight.¹⁹ European Union leaders were convinced that one of the primary drivers of the crisis was fragmented regulation

9. Helene Cooper, *Obama Signs Overhaul of Financial System*, N.Y. TIMES (July 21, 2010), <http://www.nytimes.com/2010/07/22/business/22regulate.html>.

10. The United Kingdom is a Member State to the European Union. Nonetheless, it continues to take aggressive measures to revamp its own regulatory scheme at the national level. See Eric J. Pan, *Structural Reform of Financial Regulation*, 19 TRANSNAT'L L. & CONTEMP. PROBS. 796, 831-38 (2011).

11. See *infra* Part III.

12. Pan, *supra* note 10, at 796, 798-99.

13. *Id.* at 796, 799.

14. *Id.* at 796, 800.

15. See generally *Basic Information on the European Union*, EUR. UNION, http://europa.eu/about-eu/index_en.htm (last visited Jan. 16, 2013).

16. See *How the EU Works: The Economy*, EUR. UNION, http://europa.eu/about-eu/facts-figures/economy/index_en.htm (last visited Feb. 16, 2012) (based on GDP); Thomas A. Russo & Aaron J. Katzel, *The 2008 Financial Crisis and Its Aftermath: Addressing the Next Debt Challenge* 41 (Grp. of Thirty Occasional Paper No. 821, 2011).

17. Russo & Katzel, *supra* note 16.

18. Eddy Wymeersch, *Europe's New Financial Regulatory Bodies*, 11 J. CORP. L. STUD. 443, 448 (2011).

19. *Id.*

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within the European Union.²⁰ Regulatory arbitrage, borne out of this fragmented regulatory scheme, was identified as an evil that needed to be mitigated.²¹ As such, lawmakers gave the new ESFS the power to promulgate a common technical rulebook for harmonized financial regulation across the European Union.²²

This Comment discusses the establishment of the ESFS, its rulemaking bodies, and how EU leaders can develop a common technical rulebook for financial regulation.²³ The goal is to provide an analytical framework and suggestions for approaching the challenge of legislating this rulebook.

To begin, Part II of this Comment discusses the financial rulemaking process in place prior to the recent reforms as well as the events triggering the European regulatory response. Part III outlines the European Union's response to the global financial crisis, reviewing the seminal Jacques de Larosière Report, the subsequent establishment of the ESFS, and the rationale for creating the common technical rulebook. Part IV explores the legal basis and economic context of the rulebook. Lastly, Part V focuses on how the financial rules should be enacted, arguing that an increased use of Regulations and alternative levels of harmonization are key to achieving uniform regulation that will mitigate regulatory arbitrage within the European Union.

II. REGULATORY INADEQUACIES AND A CALL FOR ACTION

A. *The Lamfalussy Process and Level 3 Committees*

To better understand the changes made by the European Union, a preliminary review of the financial rulemaking process that existed prior to the recent reforms is necessary. The existing procedures—or perhaps more precisely, the existing bodies responsible for regulatory uniformity—were eventually deemed inadequate upon post-crisis evaluation by EU leaders and advisors.²⁴

The Lamfalussy Process,²⁵ implemented in 2001, was erected in hopes of strengthening EU financial regulation²⁶ and making the legislative process more

20. See THE DE LAROSIÈRE GROUP, THE HIGH-LEVEL GROUP OF FINANCIAL SUPERVISION IN THE EU 27 (2009), available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

21. *Id.* at 27.

22. *Communication from the Commission: European Financial Supervision*, at 9, COM (2009) 252 final (May 27, 2009), available at http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf.

23. The ESRB will not be discussed in this Comment, except to the extent it is needed to illustrate the broader structural landscape of the EU reforms.

24. THE DE LAROSIÈRE GROUP, *supra* note 20, at 41-42.

25. The process was the outcome of a report issued by the Committee of Wise Men, whose original task was to recommend changes to securities legislation. The process has since been extended to other financial sectors, including banking and insurance. See Duncan Alford, *The Lamfalussy Process and EU Bank Regulation: Another Step on the Road to Pan-European Regulation?*, 25 ANN. REV. BANKING & FIN. L. 389,

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flexible in light of rapid financial innovation.²⁷ The process was meant to facilitate the enactment, interpretation, and implementation of financial legislation through four key levels.²⁸ At Level 1, the European Parliament and the Council of the European Union adopted the framework legislation of a given financial rule.²⁹ Level 2 involved the detailing of implementation measures for that legislation, denominated by industry or sector.³⁰ Level 3 provided for the technical preparation of the rule's implementation at the Member State level.³¹ Finally, Level 4 consisted of the European Commission's³² enforcement, and Member State transposition, of the legislated law.³³

In hopes of creating stronger EU-level rules, the primary target of the recent financial reforms was Level 3 of the Lamfalussy Process.³⁴ Structurally, Level 3 preparation of Member State implementation was conducted by three EU-level committees: the Committee of European Banking Supervisors ("CEBS"), the Committee of European Insurance and Occupational Pensions Supervisors ("CEIOPS"), and the Committee of European Securities Regulators ("CESR").³⁵ This group of bodies—commonly referred to as the "Level 3 Committees" or "L3 Committees"—was comprised of representatives of national supervisory bodies.³⁶ The goal of the Level 3 Committees was to ensure uniform application of the legislated rules at the national level (i.e., among the Member States).³⁷

397 (2006).

26. *Review of the Lamfalussy Process*, EUROPA, http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_general_framework/132056_en.htm (last updated June 6, 2008).

27. *Commission Staff Working Document for the Application of the Lamfalussy Process to EU Securities Markets Legislation*, at 3, SEC (2004) 1459 (Nov. 15, 2004), available at http://ec.europa.eu/internal_market/securities/docs/lamfalussy/sec-2004-1459_en.pdf.

28. *Review of the Lamfalussy Process*, *supra* note 26.

29. *Id.*; Alford, *supra* note 25, at 399. Under the Treaty on the Functioning of the European Union, which details the EU legislative process, the consent of both the Council and Parliament is required for legislative acts to be passed in the European Union. The Council is comprised of Member State representatives. Peter O. Mühlert & Alexander Wilhelm, *Reforms of EU Banking and Securities Regulation After the Financial Crisis*, 26 *BANKING & FIN. L. REV.* 187, 189 (2011).

30. *Review of the Lamfalussy Process*, *supra* note 26; Alford, *supra* note 25, at 399-402.

31. *Review of the Lamfalussy Process*, *supra* note 26; Alford, *supra* note 25, at 399-402.

32. The European Commission is responsible for promoting EU harmonization by initiating new legislation, enforcing EU treaty obligations of Member States and individuals, and exercising certain executive powers. Mühlert & Wilhelm, *supra* note 29, at 190.

33. *Review of the Lamfalussy Process*, *supra* note 26; Alford, *supra* note 25, at 399-403.

34. As part of the treaty-based framework of the European Union, the Lamfalussy Process is subject to any changes in institutional and regulatory reforms that might occur within that framework. PIERRE SCHAMMO, *EU PROSPECTUS LAW 7-8* (2011).

35. *Commission Review of the Lamfalussy Process: Strengthening Supervisory Convergence*, at 2, COM (2007) 727 final (Feb. 28, 2008), available at http://ec.europa.eu/internal_market/finances/docs/committees/071120_final_report_en.pdf.

36. *Id.*; Alford, *supra* note 25, at 402.

37. Alford, *supra* note 25, at 402.

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The Lamfalussy Process was aimed at minimizing regulatory arbitrage by providing a transparent approach that was open to input from market professionals, consumer bodies, and Member State regulators.³⁸ Nonetheless, the process proved susceptible to inconsistencies at the Member State level because national regulators had the ability to add national rules to those agreed upon by the Level 3 Committees.³⁹ This practice, referred to as “gold-plating,”⁴⁰ weakened the goals of the Lamfalussy Process and provided confusion for the role of the Level 3 Committees.⁴¹ Also, because the membership of the Level 3 Committees was comprised of national supervisors, there were instances in which a supervisor’s duty to his nation conflicted with his duty as a member of the Level 3 Committee.⁴² As one might expect, these supervisors usually favored the interests of their respective Member States over those of the Union.⁴³

Although hailed by some as having done an impressive job in light of each committee’s limited personnel and budget,⁴⁴ the Level 3 Committees were generally evaluated as having an inconsistent influence on Member State supervisors in performing their day-to-day supervisory duties at the national level.⁴⁵ The crux of the criticism aimed at the committees was that they had a poorly-defined role in the legislative process.⁴⁶

The lack of legal power vested in the Level 3 Committees was cited as the root cause of these deficiencies.⁴⁷ Although the decisions adopted by the Level 3 Committees were designed to “clearly carry considerable authority,” they were not legally binding decisions.⁴⁸ Member States could essentially override the decisions of the committees, undermining the effectiveness of the Lamfalussy Process and providing a source of regulatory fragmentation.⁴⁹ With the development of the global financial crisis, the stage was set to reform the legislative process and provide EU-level lawmakers increased power to mandate uniform financial rules and mitigate detrimental practices like gold-plating.

38. *Commission Review of the Lamfalussy Process*, *supra* note 35, at 5; Alford, *supra* note 25, at 402.

39. *Commission Review of the Lamfalussy Process*, *supra* note 35, at 5.

40. *Id.*

41. *Id.* at 5, 9.

42. *Id.* at 7.

43. *Id.*

44. KAREL LANNON, CEPS POLICY BRIEF, NO. 241, THE EU’S RESPONSE TO THE FINANCIAL CRISIS: A MID-TERM REVIEW 2 (2011), available at <http://www.ceps.eu/ceps/dld/5500/pdf>.

45. *Commission Review of the Lamfalussy Process*, *supra* note 35, at 5.

46. See *Commission Staff Working Document for the Application of the Lamfalussy Process to EU Securities Markets Legislation*, *supra* note 27, at 10.

47. See *Commission Review of the Lamfalussy Process*, *supra* note 35, at 9.

48. *Id.*

49. *Id.* at 5, 9.

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The effects of the subprime mortgage crisis that began in the United States spread quickly around the world—the European Union and its Member States were not spared.⁵⁰ Mirroring the events in the United States, a credit crunch soon developed in Europe.⁵¹ Relaxed borrowing standards in European countries were fueling higher property valuations, while national regulators ignored concerns about the dangerous increases in debt.⁵² When prices of the underlying assets began to fall, European banks were confronted with liquidity problems, which for some, grew into larger solvency problems.⁵³ A domino effect resulted where credit became leaner and increased austerity measures were implemented, both of which furthered the economic slowdown.⁵⁴

By late October 2008, a call for action from the public and European Parliament was heard by European Commission President José Manuel Barroso, who appointed a panel of experts headed by Jacques de Larosière to articulate a plan that would address the shortcomings of EU financial regulation.⁵⁵ In November 2010, the European Union answered the call by adopting a new regulatory structure based on the de Larosière Group's findings.⁵⁶

III. CALL ANSWERED: THE DE LAROSIÈRE REPORT AND FINANCIAL REFORM

A. The de Larosière Report

In response to the financial crisis and subsequent calls for action, European Commission President José Manuel Barroso recognized the need for an

50. The more technical nuances of the economic factors leading up to the crisis are outside the scope of this Comment. For a thorough discussion of the developments leading up to the crisis, with specific implications for the European Union, see Anu Arora, *The 2007-09 Banking Crisis and the EU's Regulatory Response*, 21 EUR. BUS. L. REV. 603 (2010).

51. Russo & Katzel, *supra* note 16.

52. *Id.*

53. *Id.* at 42.

54. *Id.*

55. *EU Panel on Banking Supervision Raises Concerns*, EURACTIV.COM (Oct. 23, 2008), <http://www.euractiv.com/financial-services/eu-panel-banking-supervision-raises-concerns/article-176600>.

56. *Parliament Gives Green Light to New Financial Supervision Structure*, EUR. PARLIAMENT NEWS (Sept. 23, 2010), <http://www.europarl.europa.eu/en/headlines/content/20100910FCS81938/012/html/Parliament-gives-green-light-to-new-financial-supervision-architecture>; Press Release, Council of the Eur. Union, Financial Supervision: Council Adopts Legal Texts Establishing the European Systemic Risk Board and Three New Supervisory Authorities (Nov. 17, 2010), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/117747.pdf; Council Regulation 1093/2010, 2010 O.J. (L 331) (EU), *available at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0012:0047:EN:PDF> (establishing the EBA); Council Regulation 1094/2010, 2010 O.J. (L 331) (EU), *available at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0048:0083:EN:PDF> (establishing the EIOCPA); Council Regulation 1095/2010, 2010 O.J. (L 331) (EU), *available at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0084:0119:EN:PDF> (establishing the ESMA).

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independent review of financial regulation within the European Union.⁵⁷ In late October 2008, Barroso asked Jacques de Larosière to head a High Level Group (“Group”) of financial experts to report findings and recommendations on ways to improve financial supervision in Europe.⁵⁸ In the resulting de Larosière Report (“Report”), released on February 25, 2009, the Group made thirty-one specific recommendations to the European Commission.⁵⁹ Among the advice given, the Group urged Member States and the European Parliament to avoid regulatory inconsistencies and harmonize a set of core financial rules.⁶⁰ Additionally, the Group envisioned a European System of Financial Supervisors that would be responsible for implementing this set of financial rules.⁶¹

Although it recognized that the majority of the regulatory issues encountered were candidates for broader international responses, the de Larosière Group identified the “lack of a consistent set of rules” as an issue of particular importance to the European Union.⁶² According to the Report, the structure of the European Union, comprised of a single financial market supervised by various levels of rulemakers, exposed European financial regulation to inconsistencies.⁶³ The Group advised that while EU-level rules should certainly provide a set of “minimum core standards” for harmonization, Member States should be allowed to adopt stricter standards when deemed domestically appropriate by each Member States’ national supervisors.⁶⁴ Although a minimum set of standards was

57. Press Release, Council of the Eur. Union, High Level Expert Group on EU Financial Supervision to Hold First Meeting on 12 November (Nov. 11, 2008), *available at* <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1679>.

58. *Id.*; THE DE LAROSIÈRE GROUP, *supra* note 20, at 3; Duncan Alford, *Supervisory Colleges: The Global Financial Crisis and Improving International Supervisory Coordination*, 24 EMORY INT’L L. REV. 57, 80 (2010).

59. THE DE LAROSIÈRE GROUP, *supra* note 20.

60. *Id.* at 29. The Group observed a need to “tackle the current absence of a truly harmonised set of core rules in the EU,” and it recommend that:

Member States and the European Parliament should avoid in the future legislation that permits inconsistent transposition and application; [and] the Commission and the [L]evel 3 Committees should identify those national exceptions, the removal of which would improve the functioning of the single financial market; reduce distortions of competition and regulatory arbitrage; or improve the efficiency of cross-border financial activity in the EU. Notwithstanding, a Member State should be able to adopt more stringent national regulatory measures considered to be domestically appropriate for safeguarding financial stability as long as the principles of the internal market and agreed minimum core standards are respected.

Id. (Recommendation 10). The de Larosiere report was by no means the first time the concept of regulatory harmonization was recommended. The concept has been discussed for some time, and the Lamfalussy Process was a first attempt at harmonization. See Thomas M.J. Moolers, *Sources of Law in European Securities Regulation—Effective Regulation, Soft Law and Legal Taxonomy from Lamfalussy to de Larosiere*, 11 EUR. BUS. ORG. L. REV. 379, 381 (2010).

61. *Id.* at 48, 51, 53, 56.

62. *Id.* at 27.

63. *Id.*

64. *Id.* at 28, 29.

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encouraged, complete consistency among all Member States was not identified as an ultimate end.⁶⁵

The de Larosière Group also recommended that EU officials create the European System of Financial Supervisors to control micro-prudential supervision of the Single Market⁶⁶ and promulgate the common rulebook.⁶⁷ As proposed, the ESFS would be a network of three new EU-level authorities combined with the college of supervisors (an existing system of Member State supervisors that maintained a consultative role in the Lamfalussy Process).⁶⁸ Because of the perceived ineffectiveness of the Level 3 Committees, the Group recommended that the three new authorities be vested with authority broader than the Level 3 Committees as they then existed.⁶⁹ In the Report, the three authorities were visualized as “enhanced [L]evel 3 [C]ommittees.”⁷⁰

B. Creation of the European System of Financial Supervisors

The European Commission welcomed the de Larosière Report, taking ambitious steps towards implementing many of the de Larosière Group’s recommendations, including the establishment of the ESFS.⁷¹ Decisively, the Commission drafted a package of legislative proposals based on the Report by September 2009.⁷² A year later, in November 2010, the European Parliament and

65. *Id.*

66. Micro-prudential supervision consists primarily of supervision of financial institutions. Alford, *supra* note 58, at 68. Examples of micro-prudential regulation include “certification of those working in the financial sector; rules on what assets can be held by whom; how instruments are listed, traded, sold and reported; and measures of the value and riskiness of assets.” THE WARWICK COMM’N, THE WARWICK COMMISSION ON INTERNATIONAL FINANCIAL REFORM: IN PRAISE OF UNLEVEL PLAYING FIELDS 12 (2009), available at <http://www2.warwick.ac.uk/research/warwickcommission/financialreform/report/>; see also Pablo Iglesias Rodríguez, *Towards a New European Financial Architecture*, 16 COLUM. J. EUR. L. ONLINE 1, 3 (2009). See *infra* Part IV.A. for a discussion of the Single Market.

67. THE DE LAROSIÈRE GROUP, *supra* note 20, at 48. In Recommendation 18 of the Report, the Group recommended that the ESFS be set up as a decentralized network, comprised of three groups with distinct roles:

- existing national supervisors would continue to carry-out day-to-day supervision;
- three new European Authorities would be set up, replacing CEBS, CEIOPS and CESR, with the role coordinate the application of supervisory standards and guarantee strong cooperation between the national supervisors;
- colleges of supervisors would be set up for all major cross-border institutions.

Id.

68. *Id.*

69. *Id.* at 41, 42.

70. *Id.* at 47.

71. *Communication for the Spring European Council: Driving European Recovery*, at 6, 7, COM (2009) 114 final (Mar. 3, 2009), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0114:FIN:EN:PDF>.

72. *Proposal for Regulation of the European Parliament and of the Council Establishing a European Banking Authority*, COM (2009) 501 final (Sept. 23, 2009), available at http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_501_en.pdf (proposing establishment of the EBA); *Proposal for Regulation of the European Parliament and of the Council establishing a European*

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Council approved the financial supervision package, with the ESFS to begin its work on January 1, 2011.⁷³

In its final form, the ESFS was established as a network of three bodies: (1) a set of three financial supervisors at the EU level, known as the European Supervisory Authorities (“ESAs”); (2) a Joint Committee to steer the efforts of the ESAs; and (3) a network of national supervisors responsible for day-to-day supervision at the Member State level, subject to oversight by the ESAs.⁷⁴ Broken down further, the ESAs consist of a European Banking Authority (“EBA”), based in London, England; a European Insurance and Occupational Pensions Authority (“EIOPA”), based in Frankfurt, Germany; and a European Securities and Markets Authority (“ESMA”), based in Paris, France.⁷⁵

In contrast to the Level 3 Committees, the Commission envisioned the ESAs as authorities with legal personalities having additional power and responsibilities.⁷⁶ Specifically, the new ESAs have responsibility for both regulatory and supervisory functions—the regulatory function primarily refers to rulemaking, while the supervisory function refers to application of the rules.⁷⁷ Under their regulatory power, the ESAs are responsible for developing binding technical standards and providing interpretative guidelines to assist Member State authorities in applying such rules.⁷⁸ This means that the ESAs, as part of the ESFS, have the legal authority to promulgate a common technical rulebook for financial regulation throughout the European Union.⁷⁹

Insurance and Occupational Pensions Authority, COM (2009) 502 final (Sept. 23, 2009), available at http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_502_en.pdf (proposing establishment of the EIOPA); *Proposal for Regulation of the European Parliament and of the Council establishing a European Securities and Markets Authority*, COM (2009) 503 final (Sept. 23, 2009), available at http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_503_en.pdf (proposing establishment of the ESMA).

73. Press Release, Council of the Eur. Union *supra* note 56; Press Release, Council of the Eur. Union, *supra* note 57; Council Regulation 1093/2010, *supra* note 56; Council Regulation 1094/2010, *supra* note 56; Council Regulation 1095/2010, *supra* note 56.

74. *Communication from the Commission*, *supra* note 22, at 8.

75. *Id.*; Council Regulation 1093/2010, *supra* note 56; Council Regulation 1094/2010, *supra* note 56; Council Regulation 1095/2010, *supra* note 56.

76. Alford, *supra* note 58, at 68.

77. A third, institutional function has been identified. This refers to the coordinated efforts of the ESRB and ESFS in preventing and managing financial risk in the European Union. While relevant to the success of the EU financial reforms, this function is beyond the scope of this Comment. LANNOO, *supra* note 44; Wymeersch, *supra* note 18, at 2; Nicolette Kost de Sevres & Lorenzo Sasso, *The New European Financial Markets Legal Framework: A Real Improvement?*, 7 CAP. MARKETS L. J., 30, 37 (2011).

78. *Communication from the Commission*, *supra* note 22.

79. LANNOO, *supra* note 44, at 2; *see also infra* Part IV.

*Global Business & Development Law Journal / Vol. 26**C. An Introduction to the Common Technical Rulebook*

In recommending the common technical rulebook, the de Larosière Group identified four reasons for having a harmonized set of financial rules.⁸⁰ First, the Group noted that the Single Market of the European Union, by nature, requires a consistent set of rules in order to function properly.⁸¹ Second, it was concerned that competition within the European Union would suffer if there were inconsistent financial regulations among the Member States—the Group was worried about the opportunity for institutions to practice regulatory arbitrage through gold-plating.⁸² Third, the Group observed that a fragmented regulatory environment presented magnified efficiency, risk management, and capital allocation problems for cross-border institutions.⁸³ Fourth, crisis management, especially for cross-border institutions, was deemed more difficult in a regulatory environment lacking consistent standards.⁸⁴ By recommending the implementation of a common technical rulebook, the Group was optimistic that these issues could be resolved.⁸⁵

The European Commission agreed, finding the Group's suggestion to develop a set of harmonized rules "of particular interest."⁸⁶ Beyond the four rationales identified by the de Larosière Group, the Commission noted additional benefits to a common technical rulebook at the EU level, including strengthened stability, equal treatment, and lower compliance costs.⁸⁷ The Commission premised the ability of the ESAs to establish a common rulebook on "principles of partnership, flexibility and subsidiarity."⁸⁸

IV. THE COMMON TECHNICAL RULEBOOK: ECONOMIC AND LEGAL FRAMEWORK

The development of the common technical rulebook is limited by the economic and legal setting of the European Union. Economically, regulators must be wary of the impacts their legislation will have on both the international

80. THE DE LAROSIÈRE GROUP, *supra* note 20, at 27.

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.*

85. *See id.*

86. *Communication for the Spring European Council*, *supra* note 71, at 5.

87. Press Release, Council of the Eur. Union, Financial Services: Additional Legislative Proposal to Complete the Framework for Fin. Supervision in Eur. 2 (Jan. 19, 2011), *available at* europa.eu/rapid/press-release_IP-11-49_en.pdf. Uniform laws help reduce transaction costs, especially in a diverse situation such as the European Union. For a sound discussion on the economic role of uniform laws, see John Linarelli, *The Economics of Uniform Laws and Uniform Lawmaking*, 48 WAYNE L. REV. 1387 (2003).

88. Press Release, Council of the Eur. Union, Financial Services: Commission Proposes Stronger Financial Supervision in Europe (May 27, 2009), *available at* europa.eu/rapid/press-release_IP-09-836_en.pdf.

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markets and the European Union's Single Market.⁸⁹ Legally, lawmakers must act within their affirmatively granted power and abide by the broader treaty-based principles that permeate throughout the EU legal system.⁹⁰ This Part discusses how these factors combine to provide the legal basis for enactment of the financial rules in the common technical rulebook.

A. International and Single Market Implications

While most of the attention in developing the common rulebook will focus on the European Union and its Member States, regulators must also be aware of any international implications. Every piece of legislation enacted by the ESAs will have effects felt beyond the borders of the European Union, either directly or indirectly. This is a natural consequence of the increasingly global economy.⁹¹ Likewise, the links between the international community and the European Union will have reciprocal implications within the European Union itself.⁹² The European Union, as a representative of its twenty-seven Member States, is heavily involved in a number of international economic forums—most notably, the Basel Accords, G-20 Summits, and the International Monetary Fund.⁹³ In this context, the de Larosière Group stressed that the European Union should “speak with one voice.”⁹⁴ Because of the impacts that each of these external commitments will have on the European Union's relationship with its Member States, EU leaders must be careful not to blur its goals as a Single Market regime with those it has as a global economic participant.

Within the European Union, any rules adopted under the common rulebook must be consistent with the policies of the European Union's Single Market.⁹⁵

89. See *infra* Part IV.A.

90. See *infra* Part IV.B.

91. See Herman Van Rompuy, *Foreword to THE LESSONS OF THE EUROZONE CRISIS THAT SHOULD SHAPE THE EU'S G20 STANCE*, FRIENDS OF EUROPE (2011), available at www.friendsofeurope.org/Portals/13/Events/Roundtables/2011/Taming_the_turmoil/Lessons_of_Eurozone_Crisis_that_Should_Shape_the_EU%27s_G20_Stance.pdf (noting that “[t]he destinies of the world's main economies are more intertwined than ever before.”).

92. This applies with equal force to the European Union as a whole as well as Member States in their individual capacity as players in the world economy. See Rodriguez, *supra* note 66 at 5-6.

93. See *Organisation and Governance*, BANK FOR INT'L SETTLEMENTS, <http://www.bis.org/about/orggov.htm> (last updated December 19, 2011) (noting that members are central banks or monetary authorities, including the European Central Bank); see *Relations with the IMF*, EUR. COMMISSION, http://ec.europa.eu/economy_finance/international/forums/imf/index_en.htm (last visited Feb. 16, 2012) (clarifying that while “only [individual countries] are members of the IMF, the European Union is represented therein by its Member States.”); see *About G20 Member Countries*, G20.ORG, <http://www.g20.org/infographics/20121201/780989503.html> (last visited Feb. 16, 2012) (indicating the European Union as a member).

94. THE DE LAROSIÈRE GROUP, *supra* note 20, at 29.

95. This principle is legally mandated by Article 114 of the TFEU. *Communication from the Commission*, *supra* note 22, at 14.

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The Single Market, also referred to as the Internal Market,⁹⁶ represents the efforts of the European Union and its twenty-seven Member States to promote the “four freedoms”: the free circulation of people, goods, services, and capital.⁹⁷ As described under the EU treaties, the policies served by the Single Market include promoting sustainable economic growth and competition, ensuring social progress, and fostering cohesion among the Member States.⁹⁸ Accordingly, the Regulations that created the ESFS provide that any actions taken by the ESAs, including the promulgation of the common rulebook, must be done in the context of the Single Market as a whole.⁹⁹

B. Legal Authority to Create the Common Technical Rulebook

The European Union’s source of power for creating the ESFS and the ESAs was derived from Article 114 of the Treaty on the Functioning of the European Union (“TFEU”).¹⁰⁰ Under Article 114, EU lawmakers can adopt measures that allow for the creation of a “[c]ommunity body responsible for contributing to the implementation of a process of harmonisation,” so long as that body’s responsibilities are closely linked to the functioning of the Single Market.¹⁰¹ Because one of the responsibilities of the ESAs will be to develop a common rulebook for uniform application of financial rules within the Single Market of

96. A distinction may be framed by narrowly defining the Single Market as having purely economic implications, while characterizing the Internal Market as one with both economic and social implications. Paulina Dejmek, *The EU Internal Market for Financial Services: A Look at the First Regulatory Responses to the Financial Crisis and a View to the Future*, 15 COLUM. J. EUR. L. 455, 456 (2009). For the purposes of this Comment, this distinction will be ignored, although the social implications of any financial rule will surely be considered by EU lawmakers when creating the common rulebook.

97. *General Policy Framework*, EUR. COMMISSION, http://ec.europa.eu/internal_market/top_layer/index_1_en.htm (last updated Oct. 10, 2011).

98. Consolidated Version of The Treaty on European Union art. 3, Mar. 30, 2008, 2008 O.J. (C 83) 15, available at eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2012:326:FULL:EN:PDF.

99. Paragraph 11 of each Regulation Preamble provides:

The Authority should act with a view to improving the functioning of the internal market, in particular by ensuring a high, effective and consistent level of regulation and supervision taking account of the varying interests of all Member States and the different nature of financial institutions. The Authority should protect public values such as the stability of the financial system, the transparency of markets and financial products, and the protection of depositors and investors. The Authority should also prevent regulatory arbitrage and guarantee a level playing field, and strengthen international supervisory coordination, for the benefit of the economy at large, including financial institutions and other stakeholders, consumers and employees.

Council Regulation 1093/2010, *supra* note 56; Council Regulation 1094/2010, *supra* note 56; Council Regulation 1095/2010, *supra* note 56; THE DE LAROSIÈRE GROUP, *supra* note 20, at 41, 42.

100. Article 114 of the TFEU superseded Article 95 of the Treaty Establishing the European Community (“EC Treaty”). Kost de Sevres & Sasso, *supra* note 77. For a timeline of the relevant EU treaties, see Mülbart & Wilhelm, *supra* note 29; *EU Treaties*, EUROPA, http://europa.eu/about-eu/basic-information/decision-making/treaties/index_en.htm (last visited Feb. 16, 2012).

101. *Communication from the Commission*, *supra* note 22, at 14.

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the European Union, this required nexus was satisfied when the ESFS was established.¹⁰²

Under the Regulations establishing the ESAs, the power of the ESAs to issue binding law is limited to defining technical standards related to the functioning of the Single Market.¹⁰³ The Regulations further note that the adopted rules “shall not imply strategic decisions or policy choices and their content shall be delimited by the legislative acts on which they are based.”¹⁰⁴ In other words, the laws provided under the common rulebook will be construed strictly as technical rules rather than policy-laden standards applicable in a broader context.

In addition to legislating binding technical law, the ESAs may also issue “guidelines and recommendations addressed to competent authorities or financial institutions” to assist with implementation of the technical rules enacted.¹⁰⁵ These guidelines and recommendations will have no force of law, but will promote coherent implementation of the common rules at the Member State level, contributing to the goal of harmonization.¹⁰⁶

The technical standards adopted by the ESAs may be drafted by any one of the three authorities and submitted to the Commission for endorsement.¹⁰⁷ Upon review of the draft, the European Commission will take action in one of three ways: (1) forward the legislation to the European Parliament and the Council for review and ultimate adoption; (2) ask the drafting ESA to amend the draft and resubmit an updated version to the Commission; or (3) choose not to endorse the draft in its entirety.¹⁰⁸ In cases where the drafted legislation is severable, the Commission may endorse, amend, or reject the ESA’s draft in part.¹⁰⁹

C. Legislative Toolbox: Directives and Regulations

EU lawmakers have a flexible regulatory system in which to effectuate harmonized laws within the European Union. In resolving the question of how to

102. *Id.*

103. See Council Regulation 1093/2010, *supra* note 56, at art. 10; see also Council Regulation 1094/2010, *supra* note 56, at art. 10; see also Council Regulation 1095/2010, *supra* note 56, at art. 10; LANNOO, *supra* note 44. This principle is consistent with the treaty-based limitations placed on all EU financial legislation. Consolidated Version of the Treaty on the Functioning of the European Union art. 114, May 9, 2008, 2008 O.J. (C 115) 47.

104. Council Regulation 1093/2010, *supra* note 56, at art. 10; Council Regulation 1094/2010, *supra* note 56, at art. 10; Council Regulation 1095/2010, *supra* note 56, at art. 10.

105. Council Regulation 1093/2010, *supra* note 56, at art. 16; Council Regulation 1094/2010, *supra* note 56, at art. 16; Council Regulation 1095/2010, *supra* note 56, at art. 16.

106. LANNOO, *supra* note 44.

107. Council Regulation 1093/2010, *supra* note 56, at art. 15; Council Regulation 1094/2010, *supra* note 56, at art. 15; Council Regulation 1095/2010, *supra* note 56, at art. 15.

108. Council Regulation 1093/2010, *supra* note 56, at art. 15; Council Regulation 1094/2010, *supra* note 56, at art. 15; Council Regulation 1095/2010, *supra* note 56, at art. 15.

109. Council Regulation 1093/2010, *supra* note 56, at art. 15; Council Regulation 1094/2010, *supra* note 56, at art. 15; Council Regulation 1095/2010, *supra* note 56, at art. 15.

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enact the common technical rulebook, EU lawmakers have two primary tools for enacting binding law: Directives and Regulations.¹¹⁰

Directives, founded in a principles-based approach,¹¹¹ constitute EU law that require certain end goals, but allow Member States to choose how to adapt their laws to meet those goals.¹¹² The process of implementation at the national level is known as “transposition.”¹¹³ According to the European Commission, “Directives are used to bring different national laws into line with each other, and are particularly common in matters affecting the operation of the [S]ingle [M]arket.”¹¹⁴ Thus, Directives have historically been considered a valuable tool in approaching financial legislation.¹¹⁵

As a separate instrument for EU lawmakers, Regulations constitute immediately binding law with legal force equivalent to each Member States’ own laws.¹¹⁶ Regulations are examples of rules-based regulations, which tend to provide predictability, but less discretion than principles-based regulations such as Directives.¹¹⁷ Unlike Directives, Regulations become effective without further action by the Member States.¹¹⁸ In other words, Regulations are immediately and directly applicable throughout the European Union—there is no transposition process.¹¹⁹

In contemplating legislation for the common technical rulebook, EU lawmakers must decide whether to enact financial rules as Directives or Regulations. A rule-by-rule approach is the necessary course, but, as will be discussed in the following Part, lawmakers should consider an increased use of Regulations to effectuate their goal of EU-wide harmonization.

110. *What Is EU Law?*, EUR. COMMISSION, http://ec.europa.eu/eu_law/introduction/treaty_en.htm (last updated June 25, 2011).

111. Principles-based regulation is based on the communication of certain goals and expectations between regulatory parties, as opposed to relationships in which one party directs or controls the other. Glinavos, *supra* note 1.

112. *What Are EU Directives?*, EUR. COMMISSION, http://ec.europa.eu/eu_law/introduction/what_directive_en.htm (last updated June 25, 2011); Luca Enriques & Matteo Gatti, *Is There a Uniform EU Securities Law After the Financial Services Action Plan?*, 14 STAN. J.L BUS. & FIN. 43, 48 (2008).

113. *What Are EU Directives?*, *supra* note 112.

114. *Id.*

115. See Rosa M. Lastra, *The Governance Structure for Financial Regulation and Supervision in Europe*, 10 COLUM. J. EUR. L. 49, 61 (2003).

116. *What Are EU Directives?*, *supra* note 112.

117. Glinavos, *supra* note 1.

118. *What Are EU Directives?*, *supra* note 112.

119. LANNOO, *supra* note 44.

*2013 / Financial Reform in the European Union*V. A SUGGESTED APPROACH TO ESTABLISHING THE COMMON
TECHNICAL RULEBOOK

In defining a set of harmonized technical rules to prevent and detect future financial crises, EU lawmakers have a complex task that will require a coordinated and flexible approach.¹²⁰ As discussed below, much of this task includes balancing competing interests and ideas. This Part examines these issues and develops two primary recommendations on how the common technical rulebook should be enacted. First, lawmakers should consider varied levels of harmonization to provide a flexible approach to the rulebook. Second, a wider use of Regulations, rather than Directives, should be considered in pursuit of regulatory uniformity and harmonization. For completeness, threshold considerations of legislative subject matter and regulatory responsibility are discussed first.

A. Threshold Issues: What Should Be Regulated and Who Should Regulate

EU lawmakers face a dynamic challenge in deciding *what* and *whether* to regulate certain financial subject matter. Due to the rapid proliferation of complex financial instruments and transactions throughout the world, there is an increasingly large pool of financial subject matter that has avoided regulation altogether.¹²¹ At the same time, existing subject matter may have transformed or become obsolete.¹²² Thus, the first issue in enacting any financial rule is deciding whether the subject matter is ripe for legislation—or, where regulations already exist, deciding whether those rules remain well-suited for that particular subject matter.¹²³

Practically, the issue will often be resolved by the obvious premise that the need for regulation presupposes an existing concern over potential or past financial risk.¹²⁴ In other words, the topics will present themselves.¹²⁵ Because legislation is often a response mechanism to an identified event or crisis, lawmakers usually concern themselves with resolving issues already past.¹²⁶ This was the case with the recent financial reforms and will continue to be the case

120. Press Release, Council of the Eur. Union, *supra* note 88.

121. See Alexandra Hennessy, Redesigning Financial Supervision in the European Union 7 (Mar. 3, 2011) (paper prepared for presentation), available at http://euce.org/eusa/2011/papers/12d_hennessy.pdf (discussing the difficulty in financial lawmaking due to “continuously evolving [financial markets] as a result of innovation and international integration”).

122. *See id.*

123. *See id.*

124. *See generally* Pan, *supra* note 10, at 813.

125. *See generally id.*

126. *Id.*

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going forward.¹²⁷ At the same time, lawmakers must be careful not to fall prey to hasty judgment—it is easy to react impulsively to a crisis while either ignoring future events or overcompensating for the crisis in a way detrimental to future developments.¹²⁸ As such, the standards adopted under the common technical rulebook should address current issues, but also be agile enough to address future risks and perpetually new financial subject matter.¹²⁹

The question of *who* should regulate focuses on the choice between establishing a financial rule at the EU level or the Member State level.¹³⁰ While the ESAs may have the legal authority to legislate a certain financial rule at the EU level, other practical or prudential considerations may deter them from doing so. As would be expected, these considerations are susceptible to divergent theories about degrees of regulatory centralization and the practice of legislative federalism, providing a possible source of conflict between EU authorities and individual Member States.¹³¹

A logical maxim of financial regulation states that “the structure of [a] regulatory system needs to reflect the structure of the markets that are regulated.”¹³² This principle, which speaks to degrees of regulatory centralization, becomes harder to apply when there is a multilayered system of regulatory authorities, such as in the case the European Union.¹³³

Historically, there exist two contrasting views with respect to what degree of regulatory centralization is needed in the European Union.¹³⁴ The first view, generally favored by the more affluent Member States such as the United

127. While there was certainly a European call for responsive reform, a broader channel for change was submitted under the G-20 summits. In the European Union, the establishment of the ESRB and the ESFS have been movements of reform beyond the framework developed at the G-20 summits. Alford, *supra* note 58, at 60.

128. See Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39 (2009) (discussing the issue primarily in the context of U.S. financial reforms).

129. See Hennessy, *supra* note 121, at 28.

130. EU-level legislation preempts Member State law to the extent there is a conflict. The concept of shared competence, derived from the principle of conferral, implies that Member States may take action so long as EU-level regulators have not exercised their competence to legislate. This concept affects the extent to which subject matter can be regulated at the EU level (or, in the negative, the extent to which Member States cannot regulate certain subject matter). Consolidated Version of The Treaty on European Union, *supra* note 98, at art. 5; Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Communities, Dec. 13, 2007, 2007 O.J. (C 306) 2; Dejmek, *supra* note 96, at 457. Broadly speaking, this concept is similar to the concept of concurrent jurisdiction between state courts and federal courts in the U.S. judicial system.

131. See, e.g., *Written Evidence From the British Bankers' Association*, U.K. PARLIAMENT: EUR. SCRUTINY COMM. (Jan. 13, 2012), available at <http://www.publications.parliament.uk/pa/cm/201012/cmselect/cm/euleg/1817/1817vw04.htm> (questioning whether there is a need for “more or less Europe” in U.K. bank regulation).

132. Lastra, *supra* note 115, at 51 (citing Richard K. Abrams & Michael Taylor, Issues in the Unification of Financial Sector Supervision, International Money Fund, Monetary and Exchange Affairs Department, (IMF Working Paper No. WP/00/213, 2000).

133. See *id.*

134. *Id.* at 55.

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Kingdom, is premised on achieving harmonization through greater cooperation between national authorities, competitive pressures, and self-regulation.¹³⁵ This view supports a decentralized structure and would put more legislative power in Member State authorities.¹³⁶ Sitting on the opposite end of the spectrum, the second view promotes a centralized architecture, with more regulatory power vested in the primary federal body rather than national authorities.¹³⁷

Before the de Larosière Report and the creation of the ESRB and ESFS, the concept of a single regulatory authority at the EU level had been discussed for some time.¹³⁸ Critics of a single-supervisor system feared that regulatory centralization would provide an excessive concentration of power and lack of accountability, overriding the basic premises of federalism.¹³⁹

As recommended by the de Larosière Group and enacted by EU leaders, the formulation of the ESRB and ESFS appears to effectuate a middle ground by forming a hybrid approach. In particular, the structure of the ESFS allows for centralized rulemaking at the EU level through the common rulebook, while mitigating dangers of regulatory abuse by allowing the existing college of supervisors to handle day-to-day supervision at the national level.¹⁴⁰ Thus, the ESAs have been dubbed “embryonic federal supervisory authorities,” whose success will depend on both their internal management and their cooperation with national supervisors.¹⁴¹

With this coordinated approach in mind, the relevance of supervision to the analysis of the common rulebook becomes apparent: the structure adopted by the European Union provides a formula in which rules and supervision appear to have an inverse relationship.¹⁴² Where the details of EU-level rules are less comprehensive, the ESAs may demand stricter supervision at the national level.¹⁴³ Conversely, where EU-level rules are technically robust, less Member State supervision is warranted.¹⁴⁴

This regulation-supervision dichotomy sheds light on how EU lawmakers can juggle the difficult balancing act they face in creating the common technical rulebook. The ESAs are to abstain from engaging in the “Europeanisation” of all financial supervision in the European Union,¹⁴⁵ while trying to ensure the stability

135. *Id.*

136. *Id.*

137. *Id.*

138. *See generally id.*

139. *Id.* at 52.

140. *See supra* Part III.

141. LANNOO, *supra* note 44, at 2.

142. *See generally* Hennessy, *supra* note 121.

143. *Id.*

144. *Id.*

145. Press Release, Council of the Eur. Union, Financial Supervision—Frequently Asked Questions 4 (May 27, 2009), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/251&type=HTML>.

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the Single Market through uniform financial regulation.¹⁴⁶ If the ESAs yield to Member States by providing for less obtrusive financial rules at the EU level, they should require a higher level of EU-level supervision, and vice versa. In this light, the success of the common rulebook will depend on *how* lawmakers go about enacting EU-wide financial rules.

B. How the Rules Should Be Enacted: Toward a Broader Use of Regulations and Alternative Degrees of Harmonization

Although EU lawmakers must abide by the legal and economic backdrop of the European Union, they now have increased power and flexibility to regulate the Single Market in a uniform manner.¹⁴⁷ This Section explores how EU leaders can fine-tune financial rules through an increased use of Regulations and varying degrees of harmonization. The goal is to account for the regulatory flexibility demanded by the unique nature of the European Union, while at the same time achieving the level of harmonization envisioned by the de Larosière Group and the European Commission in recommending the common technical rulebook.¹⁴⁸

Prior to the recent financial crisis, Directives were the preferred method for achieving financial integration within the European Union.¹⁴⁹ In the eyes of lawmakers, the flexibility of Directives facilitated a framework that respected and integrated Member States' legal and cultural traditions.¹⁵⁰ Additionally, Directives were consistent with the desired principles of minimum harmonization and mutual recognition.¹⁵¹ On the other hand, Regulations were used sparingly because they were tailored toward the principle of full or detailed harmonization, leaving little room for adaptive integration by national supervisors.¹⁵²

Undoubtedly, the use of Directives is less encroaching on Member States as individual sovereigns.¹⁵³ But in using Directives to provide minimum standards, there is an increased exposure to the formation of divergent national regimes,¹⁵⁴ making it difficult for EU-level regulators to assess and enforce the implementation of harmonized laws.¹⁵⁵ As expressed by the de Larosière Report,

146. *Id.* at 5.

147. *See supra* Part IV.

148. *See supra* Part III.

149. Lastra, *supra* note 115, at 61.

150. Dejmek, *supra* note 96, at 459.

151. *See* Lastra, *supra* note 115, at 61.

152. *See generally id.* Of course, Member State voices were heard during the initial legislative process, with national authorities playing important consultative roles. FIN. SERVICES AUTH., *supra* note 1, at 100. This representation remains alive and well, as the college of supervisors is one of the foundational pillars of the ESFS. *See supra* Part III.A.

153. *See* Dejmek, *supra* note 96, at 459.

154. *See id.*

155. *See id.*

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one of the primary goals of the financial reforms was to mitigate this type of exposure and ease the implementation of uniform law.¹⁵⁶

Strangely, the de Larosière Group pointed out that in promulgating the common rulebook, the ESAs should provide a *minimum* set of harmonized rules, allowing Member States to add stricter rules at the national level.¹⁵⁷ A narrow reading of this recommendation would seem to add little to what was already being achieved through the use of Directives.¹⁵⁸ Permitting Member States to adopt stricter rules within their respective sovereigns would perpetuate the existence of regulatory arbitrage, an evil which both the de Larosière Group and the European Commission identified as a source of financial risk within the European Union.¹⁵⁹

Instead of maintaining strict adherence to the concept of minimum harmonization, EU lawmakers should also consider the concepts of maximum harmonization or a range of harmonization. These alternative degrees of harmonization will allow for flexibility depending on what is being regulated while ensuring the ultimate goal of uniform regulation.

Maximum harmonization requires that Member States adopt the rule at face value, without the option to impose stricter rules.¹⁶⁰ Such harmonization should be used where the interest in maintaining strict uniformity outweighs Member States' interests in having regulatory choices and the ability to fine-tune EU-wide rules.¹⁶¹ In other words, where a regulatory approach is unanimously agreed-upon at the EU and Member State levels, maximum harmonization should be implemented.¹⁶² Of course, rules enacted with maximum harmonization must be tailored with the utmost detail to prevent any deviation and gold-plating.

As an additional alternative, using a range of harmonization provides flexibility through the use of one of two methods: mandated flexibility based on state-by-state fluctuations,¹⁶³ or options between multiple but mandatory rules.¹⁶⁴ While use of ranges provides the most flexibility, it is susceptible to the same evils as minimum harmonization—namely, regulatory arbitrage due to inconsistencies or loopholes. The diverse nature of the constituent Member States that make up the European Union will likely force the frequent use of

156. See THE DE LAROSIÈRE GROUP, *supra* note 20, at 29.

157. See *id.*

158. See Lastra, *supra* note 115, at 61.

159. See *supra* Part III.

160. Luca Enriques & Matteo Gatti, *Is There a Uniform EU Securities Law After the Financial Services Actoin Plan?*, 14 STAN. J.L. BUS. & FIN. 43, 49 (2008).

161. *Id.*

162. See generally Alexandra Hennessy, Presentation at EUSA Conference: Redesigning Financial Supervision in the European Union, (Mar. 3, 2011), available at http://euce.org/eusa/2011/papers/12d_hennessy.pdf (characterizing and advocating against the concept as one of “hard law”).

163. Enriques & Gatti, *supra* note 160, at 49.

164. See *id.*

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harmonization ranges in pursuit of EU-wide regulatory uniformity. Nonetheless, any such use should minimize the amount of discretion given to national regulators by allowing fluctuations based on objective measures.¹⁶⁵

The choice between enacting rules as Regulations or Directives goes hand-in-hand with the choice among levels of harmonization. A principles-based solution to mitigating regulatory arbitrage, which could be achieved through Directives, would be to improve cooperation among the national regulators to minimize the differences in laws.¹⁶⁶ When considering the role of national supervisors in the structure of the ESFS, the European Commission expressed its hope that it had indeed provided this solution.¹⁶⁷ It envisioned that national supervisors would take an institution-wide view regarding supervision, rather than views favorable to their respective nations.¹⁶⁸ Although this is a laudable solution, it is meaningless without a strict rule-based regulation to fall back on.¹⁶⁹ This is why the Lamfalussy Process failed; there was no hard-law mechanism for EU-level regulators to ensure uniformity among the Member States.¹⁷⁰

Under the new hybrid approach of the ESFS, discussed above, the regulation-supervision dichotomy requires that if Member States are given more supervisory latitude, then stricter technical rules should be in place as a check on this power.¹⁷¹ To this end, EU lawmakers should not only go outside the box and consider varying levels of harmonization, but they should also enact rules in the form of Regulations to ensure the desired level of uniformity is precisely tuned.

Of course, the ESAs must be conscious of the balance between ensuring a sound regulatory scheme while still fostering competition and growth.¹⁷² In recommending an increased use of Regulations, the primary risk is that of possible over-regulation, which may burden Member States and their constituents by preventing cross-border institutions from doing business in a cost-effective manner.¹⁷³ Such over-regulation would also sacrifice the ideals of the Single Market.

165. For example, the Capital Requirements Directives that are currently in force use a range of harmonization by providing a menu of discretionary choices to Member States. *See* Council Directive 2006/48, 2006 O.J. (L 177) 1 (EC); Council Directive 2006/49, 2006 O.J. (L 177) 201 (EC). These Directives should be reassessed to eliminate discretion subject to abuse.

166. *See* Pan, *supra* note 10, at 800.

167. *See* Alford, *supra* note 58, at 69.

168. *See id.* This favoritism marked one of the flaws of the newly-replaced Level 3 Committees. *Commission Review of the Lamfalussy Process: Strengthening Supervisory Convergence*, *supra* note 35, at 7.

169. *But see* Hennessy, *supra* note 162 (arguing for a sustained use of “soft law” cooperation at the Member State level).

170. *See Commission Review of the Lamfalussy Process*, *supra* note 35, at 9.

171. *See supra* Part V.A.

172. Pan, *supra* note 10, at 812.

173. On the other hand, under-regulation may perpetuate the existence of regulatory arbitrage and result in a loss of confidence in the Single Market. *See id.*

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While these concerns implicate the dispute over what degree of centralization is necessary, Member States worried about over-regulation may be appeased by keeping in mind two legal limitations on the ESAs' ability to legislate financial regulation. First, the common rulebook is limited to only technical financial rules.¹⁷⁴ Second, the treaty-based principle of proportionality limits lawmakers by requiring that their acts not go beyond what is necessary to achieve the objectives of Article 114 of the TFEU.¹⁷⁵ For the purposes of enacting the common rulebook, the regulatory objectives are defined by the Single Market concept.¹⁷⁶ Together, these limitations mean that the financial regulations enacted must be purely technical and narrowly tailored to support the Single Market.¹⁷⁷ Considering these checks on the power of the ESAs, it is clear that any financial legislation considered at the EU level will be heavily scrutinized before being added to the common technical rulebook.¹⁷⁸

Regardless of one's view on the appropriate degree of regulatory centralization, the bargain in a harmonized regime like the European Union is that Member States forego their ability to maintain independent requirements, while each nation reaps benefits from the broader impacts of the Single Market—namely, enhancement of freedoms of movement and establishment among the entire European Union.¹⁷⁹ The ultimate goal is a healthy Single Market, and uniformity in certain areas of financial regulation is required to meet that end.¹⁸⁰ Through a broader use of Regulations, EU-level authorities will take pressure off their national counterparts, allowing Member States to concentrate on their local markets with the knowledge that there is a level playing field across the European Union.

VI. CONCLUSION

The financial reforms in the European Union provide a useful model for discussing forward-looking practices of financial rulemaking.¹⁸¹ Because other

174. See *supra* Part IV.B.

175. See Andrea M. Corcoran & Terry L. Hart, *The Regulation of Cross-Border Financial Services in the EU Internal Market*, 8 COLUM. J. EUR. L. 221, 230 (2002).

176. See *supra* Part IV.B.

177. See *supra* Part IV.B.

178. See, e.g., EUR. SCRUTINY COMM., *Written Evidence From the British Bankers' Association*, PARLIAMENT.UK (Jan. 13, 2012), <http://www.publications.parliament.uk/pa/cm201012/cmselect/cmeuleg/1817/1817vw04.htm>.

179. Corcoran & Hart, *supra* note 175, at 237 (2002).

180. See *supra* Part II.A.

181. See generally YANNOS PAPANTONIOU, FRIENDS OF EUROPE, THE LESSONS OF THE EUROZONE CRISIS THAT SHOULD SHAPE THE EU'S G20 STANCE (2011), available at <http://www.friendsofeurope.org/Contentnavigation/Library/Libraryoverview/tabid/1186/articleType/ArticleView/articleId/2556/The-Lessons-of-the-Eurozone-Crisis-that-Should-Shape-the-EU-G20-Stance.aspx> (discussing Europe's "unique chance to lead by example" in the context of the Eurozone crisis, which is equally applicable in the context of

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global financial reforms are still in their early stages, many regulators and institutions are eagerly watching how the European Union handles its new financial rulemaking duties.¹⁸² The role of the ESFS, and in particular the ESAs, in promulgating a common technical rulebook within the European Union may ultimately prove to be a grand experiment in demonstrating whether the concept of a Single Market is actually sustainable.¹⁸³ Regardless, EU leaders have recognized regulatory arbitrage as a present-day evil that should be combatted through harmonized financial regulation.¹⁸⁴

Within the European Union, the availability of regulatory subsidies that vary from nation to nation provides enterprising institutions opportunities to practice regulatory arbitrage.¹⁸⁵ The narrow risk is that such practices may undermine regional stability in the European Union, while the larger threat is that there are areas that remain susceptible to regulatory arbitrage at a global scale.¹⁸⁶ In enacting the common technical rulebook, EU leaders will attempt to mitigate regulatory arbitrage while minimizing hindrances to market competition among its Member States. To this end, EU lawmakers should consider varying degrees of harmonization and a wider use of Regulations when enacting uniform financial rules.

the common technical rulebook).

182. Marine Cole, *Regulatory Arbitrage: Fact, Fiction or a Little of Both?*, TABB FORUM (May 17, 2011), <http://tabbforum.com/opinions/regulatory-arbitrage-fact-fiction-or-a-little-bit-of-both>.

183. See generally Van Rompuy, *supra* note 91 (referring to Europe as both an economic and political “project”).

184. See THE DE LAROSIÈRE GROUP, *supra* note 20, at 27.

185. See generally Santiago Carbo-Valverde, Edward J. Kane & Francisco Rodriguez-Fernandez, *Regulatory Arbitrage in Cross-Border Banking Mergers within the EU* (June 7, 2010) (unpublished working paper), available at <http://ssrn.com/abstract=1619159> (exploring cross-border M&A activity within the European Union, recommending statistical models to monitor regulatory arbitrage with respect to M&A activity).

186. As between the powerhouse economies of the United States and the European Union, these include derivatives, proprietary trading, bank capital requirements, and off-balance sheet securitization. Cole, *supra* note 182.