A view from Brussels
The Lamfalussy process at 13 – Troublesome teenage years ahead?

Virtually all of the post crisis EU financial services legislation has emerged from the so-called “Lamfalussy process”. That process was born 13 years ago here in Brussels and has an illustrious and aristocratic lineage, sprung from the loins of the Council of the EU and Baron Alexandre Lamfalussy. A group of Wise Men even presided over the birth. Like many early adolescents, it enjoyed a substantial growth spurt in 2011 which changed the way the world saw it. This article looks ahead to the difficult teenage years for the Lamfalussy process and wonders how it will deal with the fast changing world around it.

The Lamfalussy process has its origins in the “Committee of Wise Men on the Regulation of European Securities Markets” which was convened by the Council of the EU on 17 July 2000 with a mandate to develop proposals for making the regulatory process for EU securities legislation more flexible, effective and transparent. The Committee was chaired by Baron Lamfalussy. In March 2001, the Committee’s report recommended that the EU adopt a four-level legislative procedure that involves the following:

- legislative act (Level 1) – framework legislation is proposed by the European Commission (the Commission) and adopted under the ‘ordinary legislative procedure’. Individual articles in that legislation specify where power is delegated to the Commission to adopt Level 2 measures;

- implementing measures drafted and adopted by the Commission (subject to European parliamentary approval in some cases), following advice from the ‘specialist committees’ (Level 2);

- consultation and guidance (Level 3); and

- supervision and enforcement, principally by the regulators in each Member State (Level 4).

The growth spurt in 2011 came in the form of a European System of Financial Supervisors (ESFS), including three new pan-European Supervisory Authorities (ESAs) to replace the Committees of national regulators which had formerly provided guidance and advice at Levels 2 and 3 of the process:

- the European Banking Authority (EBA);

- the European Insurance and Occupational Pensions Authority (EIOPA); and

- the European Securities and Markets Authority (ESMA).

The ESAs were established to oversee the financial system at a micro-prudential level, to achieve convergence between Member States on technical rules and to provide a renewed measure of coordination and consistency between national regulators. The ESAs’ powers are, however, far more than merely advisory, extending to the mediation of disputes between national regulators and, in some exceptional cases, imposing requirements on them.
Some commentators have argued that the resulting legislative process for EU financial services legislation is now more transparent, with better involvement of external stakeholders and enhanced political cooperation between the trilogue legislative institutions (the European Commission, the Council of the EU and the European Parliament). I would contend, however, that the evolution of the ESAs and the changes that have occurred in the aftermath of the financial crisis have not necessarily resulted in a more efficient or effective legislative process.

Indeed, I foresee four problem areas for the Lamfalussy process in its teenage years:

• dealing with the scale and ambition of the legislative package put forward by EU politicians;

• the prevalence of Regulations rather than Directives as a legislative tool;

• the fragmentation of the G-20 consensus on financial regulatory issues and related inconsistencies between the EU and United States in the implementation of G-20 commitments; and

• the quality and coherence of Level 1 and Level 2 legislation.

THE SCALE AND AMBITION OF THE LEGISLATIVE PACKAGE

The past three years have seen a plethora of new EU initiatives in the financial services arena. Many of these initiatives stem from G-20 commitments to strengthen the regulatory regime applicable to banks and investment firms, and to impose an entirely new regulatory infrastructure on OTC derivatives.

While the policy objectives behind these initiatives are, from a neutral's perspective, admirable, the scale of the regulatory change involved has inevitably led to complexities and practical problems. In the field of OTC derivatives regulation, for example, through the EMIR and MIFID II legislation, the difficulty of achieving an EU consensus on such a wide range of issues has meant that the Level 1 legislation has been far more skeletal than can surely have been intended by the founding fathers of the Lamfalussy process. The result has been that market participants have had only broad headings and general intimations of policy intent (in extensive recitals) to go on when planning their response to legislation. Meanwhile the practical impact and some of the basic requirements on market participants are left to be resolved in Levels 2 and 3 in the process.

In the case of EMIR, much of the critical detail around the application of the Regulation has even been left to informal Q&A guidance prepared by ESMA, which is not legally binding and exists outside the Lamfalussy process. There is no official consultation or discussion process before ESMA publishes its Q&A, notwithstanding the fact that critical policy choices are often being effected through revisions to this guidance. Some market practitioners have referred to the practice of updating this guidance at short notice, without consultation, as “regulation by ambush”.

REGULATIONS VS. DIRECTIVES

The Lamfalussy process envisaged that many financial services initiatives would take the form of Directives, which – unlike Regulations – are not directly binding in the national laws of EU Member States. Following the creation of the ESAs and the drive towards a “Single Rulebook” in financial services, the introduction of new rules relevant to financial services has increasingly taken the form of directly applicable Regulations.
While the policy objectives behind this change – to maximise harmonisation and minimise divergence (and thus the potential for regulatory arbitrage) among the Member States – is understandable, the result has been a policymaking process in which the power of the ESAs has been enhanced at the expense of the powers of national legislators and regulators. The ESAs have struggled to find the time, expertise and resources to fulfil the key policymaking and guidance role previously performed by national governments, national regulators and the original Level 3 committees of supervisors that preceded the ESAs. Despite calls in the European Parliament for a significant increase in funding for the ESAs, they remain organisations that are so under resourced that they struggle to perform the tasks assigned to them effectively. As a result, market participants have generally found it more difficult to engage with the ESAs than is the case with national regulators.

THIRD COUNTRY ISSUES

Following the financial crisis, it was realised that some global co-ordination of the financial services regulatory regime was required. The 2009 G-20 London summit decided to establish the Financial Stability Board (FSB) to provide a forum to monitor regulatory developments and provide recommendations on the regulatory objectives set in G-20 meetings.

The Lamfalussy process was not designed to respond to the rise of such global standards; there is no requirement for legislators or the ESAs to take into account FSB recommendations or common standards when taking policy decisions. Nor is there a legally binding requirement for ESAs to work with governments and regulators outside the EU to minimise cross-border inconsistencies and duplication in the implementation of G-20 commitments on regulatory reform. The result is a number of areas of divergence between the regulatory regime in the EU and other major economies.

Indeed, the changes to the regulatory regimes for OTC derivatives in the US and EU have particularly highlighted this trend. Although superficially similar, the relevant provisions of the Dodd-Frank Act and EMIR differ in some fundamental areas such as the scope of derivatives regulation and the application of rules to branches of financial institutions. In banking, we have seen a move away from the initial G-20 consensus on prudential issues towards capital and liquidity standards being implemented in different ways and at different rates in the EU and US.

THE QUALITY AND COHERENCE OF LEGISLATION

It would take a brave lawyer to argue that the Lamfalussy process has resulted in legislation that it is clear, coherent and easy to apply in practice. A more realistic view is that the opposite is true, and that a process that produces legislation as poorly drafted as, for example, the Capital Requirements Regulation (CRR) must be inherently flawed. This is not a complaint that is confined to English lawyers who are used to the literal interpretation of legislation. It is a complaint that we hear from leading lawyers in all of the major financial jurisdictions in the EU, who are concerned about EU legislation that is beset by lack of clarity, internal inconsistencies and repetition.

Regulators have also mentioned to us the difficulties that they are having in interpreting EU legislation, citing the poor quality of the drafting in the CRR in particular. Recitals, which are particularly important when it comes to understanding the purpose of the legislation and resolving unclear definitions, are proving to be especially troublesome: they are often meandering and endlessly repetitive. The recitals to the Recovery and Resolution Directive contain no less than four differently drafted explanations of the purpose and objectives of resolution.
The appearance is of a legislative process that lacks proper legal oversight and has no connection with the reality of implementation following enactment. The suspicion is that in numerous cases legal certainty is deliberately sacrificed to meet the imperative of reaching agreement, leaving text that, when taken as a whole, can mean a number of different things. This allows those who disagreed with the principles underlying legislative provisions plenty of opportunity to interpret the legislation in a manner that frustrates its effective implementation.

WHAT CAN BE DONE?

The issues described above are not just esoteric legal arguments around legislative process; they have major implications for the competitive position of the EU financial services market and the ability of that market to assist the recovery of the EU economy.

The Lamfalussy process, as amended by the introduction of the ESFS, will continue to struggle with these changes if it carries on as before. Here in Brussels, I sense there is no great desire to turn back from the continued expansion of the power of the ESAs in the EU financial services regulatory architecture. There must be some merit, however, in looking again at a legislative process which was not designed for quite such an ambitious agenda. In particular, I suggest the following changes should be considered:

• if the current trend towards using Regulations rather than Directives continues, there should be an expansion of the content and detail in Level 1 Regulations: more flesh on the bones. This may drag out the political process in some cases, but I think it is right for the legislators of the EU to be doing the legislating, rather than leaving important policy choices effectively in the hands of the ESAs;

• a greater role for the FSB to be agreed with the other G-20 nations. In the legislative process, this should be accompanied by making it a clear obligation in the process to comply with, or explain non-compliance with, FSB recommendations on financial services;

• a clear and legally binding requirement for EU institutions to strive for convergence with non-EU jurisdictions in the implementation of the G-20 reform agenda;

• an end to voluminous Q&A documents issued by the ESAs, or at the very least clarification on the role of such documents within the legislative process and their legal effect;

• action to improve the quality of EU financial services legislation. I suggest two steps in the short term:
  
  - First, there should be a continual process of independent legal review of legislative texts as they evolve through the Lamfalussy process. The main purposes of this review would be (i) to establish that the text would, if enacted, possess sufficient legal certainty to be implemented effectively (and to suggest changes if that is not the case), (ii) to draw attention to and suggest ways of eliminating internal inconsistencies and contradictions within the text as a whole and (iii) generally to exercise quality control over the drafting of the text. Independent legal functions exist in many Member States to perform this task in relation to their domestic legislation during the legislative process (often comprising specialist legislative draftsmen attached to national parliaments). No such function exists and operates effectively yet in relation to EU legislation. In my view it is essential that this is rectified as soon as possible.
Second, the Commission should lead a project to develop a more coherent and detailed set of drafting conventions for EU legislation. The drafting manuals that currently exist are insufficient. Until the quality of EU legislation improves it will continue to disrupt rather than enhance the internal market as regulators struggle to implement it in a consistent way across the EU and market participants waste time and money trying to understand what it means.

The Lamfalussy process was last reviewed in 2007. As is the case for many teenagers, I submit that the process would benefit from some further testing to determine in which areas the troublesome pupil "could try harder".

Michael Sholem
Special Adviser, European Financial Regulatory Affairs