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# Capital markets union: "ever closer union" for the EU financial system

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**Capital Markets Union: "Ever Closer Union" for the EU Financial System?**


## Abstract

A period of stability might have been expected following the epochal crisis-era reforms to financial system governance in the EU. Instead, however, the EU is preoccupied with a new reform agenda – the Capital Markets Union (CMU) project. This article assesses whether the CMU project is likely to achieve the market transformation it seeks, how institutional factors are likely to shape the CMU project, and how it might change regulatory and supervisory governance for the EU financial system. It suggests that a complex feedback loop is likely to develop between single market and euro area interests with respect to CMU, and that the CMU project may consequently signal whether EU financial system governance is on a path to convergence or divergence. The CMU project may also reveal the extent of the impact of the European Council's February 2016 New Settlement for the UK within the EU on EU financial governance.



Keywords: Capital Markets Union; Banking Union; Financial Union; financial governance; securitization; Prospectus Directive; political economy; EU financial system; financial crisis; EU financial regulation; market finance

## Introduction: why Consider Capital Markets Union?

### *The New Reform Agenda*

After the behemoth regulatory, supervisory, and institutional financial-crisis-era reforms carried out over 2008-2014,[1] and the radical Banking Union institutional reforms adopted over 2012-2014,[2] a period of calm and reflection might have been predicted for EU

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[1] For assessment see: D. Ioannou, B. Leblond, and A. Niemann, "European Integration and the Crisis: Practice and Theory" (2015) 22(2) Journal of European Public Policy 155; *N. Moloney, EU Securities and Financial Markets Regulation (Oxford University Press, 2014*); and *E. Ferran, "Crisis*-*driven Regulatory Reform: Where in the World is the EU Going?" in E. Ferran, N. Moloney, J. Hill, and C. Coffee, The Regulatory Aftermath of the Global Financial Crisis (Cambridge University Press, 2012), pp. 1-110.*

[2] Banking Union governance covers euro-area Member States (on a mandatory basis) and other "participating Member States" (on a voluntary basis). Within Banking Union, the harmonized pan-EU banking 'single rule-book' applies, but bank supervision and early intervention takes place within the Single Supervisory Mechanism, and bank rescue and resolution operates within the Single Resolution Mechanism. From the burgeoning literature see: *D. Busch and G. Ferrarini (eds), European Banking Union (Oxford University Press, 2015)*; K. Alexander, "A Legal and Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism" (2015) 40 European Law Review 154; N. Moloney, "European Banking Union: Assessing its Risks and Resilience" (2014) 51(6) Common Market Law Review 1609; and B. Wolfers and T. Vorland, "Level the Playing Field: the New Supervision of Credit Institutions by the European Central Bank" (2014) 51(5) Common Market Law Review 1463.

financial system governance.[3] But, and with some fanfare, the EU is now embroiled with the Capital Markets Union (CMU) project.

The CMU reform agenda was launched by Commission President Juncker in October 2014,[4] given initial shape by the Commission's February 2015 Green Paper,[5] and articulated in the Commission's September 2015 Action Plan.[6] The CMU agenda is designed to "build a true single market for capital" and to "strengthen investment for the long term."[7] It reforms are organized around a number of related themes: the "path to growth" (early stage funding for start-ups and for small and medium-size enterprises (SMEs) – this form of funding is often termed the "funding escalator"); facilitating company access to the public markets; investing for the long term and for infrastructure, and sustainable investment; fostering retail and institutional investment; leveraging banking capacity to support the economy; and facilitating cross-border investing. The CMU agenda has four objectives: to unlock more investment from the EU and the rest of the world; to better connect financing to investment projects across the EU; to make the

[3] EU financial system governance is characterized here as the rules, supervisory arrangements, and institutional structures which support the single EU financial system (primarily, for the purposes of this discussion, the EU banking and capital markets).

[4] A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change. Political Guidelines for the next European Commission, 22 October 2014.

[5] *Commission, Green Paper. Building a Capital Markets Union COM (2015) 63 final.*

[6] *Commission, Action Plan on Building a Capital Markets Union COM (2015) 468 final.*

[7] *Commission CMU Green Paper, p. 2.*

financial system more stable; and to deepen financial integration and increase competition.[8]

The main pillars of the CMU agenda thus far are the proposed reforms to the harmonized EU prospectus regime which governs access to the capital markets by companies (a proposal was presented in November 2015[9]); and the proposed harmonized EU regime for securitizations,[10] which includes a specific regime for "standard, transparent, and simple" securitizations[11] (political agreement on the securitization regime was reached by the ECOFIN Council in December 2015). The prospectus reform re-orders the current

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[8] *Commission CMU Action Plan, p.3.*

[9] *Commission, Proposal for a Regulation of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading COM (2015) 583 final.*

[10] Securitization refers to the process whereby loan assets (such as mortgages and loans to SMEs) are pooled together and moved from the balance sheet of a bank. This is achieved by means of structures which issue securities which generate returns from the underlying/repackaged loan assets according to the particular risk/return profile of the securities; these securities are typically marketed to institutional investors. Risk is accordingly diffused across market actors, loan assets are removed from bank balance sheets, and bank balance sheets can accordingly sustain more lending activity.

[11] *Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms COM (2015) 473 final*; and *Commission, Proposal for a Regulation of the European Parliament and of the Council laying down common rules on securitization and creating a European framework for simple, transparent and standardized securitization COM (2015) 472) final*. The proposed regime draws on *Commission, An EU Framework for Simple, Transparent, and Standardized Securitization (2015*). Related amendments have also been made to the Solvency II regime (C(2015) 6588/2).

Prospectus Directive[12] into a Regulation and proposes a series of largely deregulatory reforms designed to facilitate capital-raising, particularly by smaller companies. The securitization reforms are designed to stream-line the current patchwork of rules which apply to securitizations (notably with respect to due diligence, risk retention, and transparency requirements); to make the capital treatment of securitizations more risk sensitive; and to introduce a new harmonized regime for the identification and regulation/supervision of "standard, transparent, and simple" securitizations (including a more risk-sensitive capital treatment) which is designed to promote such securitizations and thereby to increase bank lending capacity. Specific reforms are also underway with respect to covered bonds[13] and to the harmonized European Venture Capital Fund (EUVECA) and European Social Entrepreneurship Fund (EUSEF) regimes.[14]

These specific initiatives are accompanied by a diffuse and often vague series of long-term reform ambitions relating to: the facilitation of SME access to finance, including through reform of financial reporting requirements for SMEs, enhancement of data sources on SME credit status, and support of a pan-EU private placement funding market which facilitates direct investment in SMEs; the support of corporate bond markets; the enhancement of alternative means of financing, including crowdfunding; the

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[12] Directive 2003/71/EC [2003] OJ L345/64.

[13] *Commission, Consultation Document. Covered Bonds in the European Union (2015).*

[14] Regulation 345/2013 [2013] OJ L115/1 and Regulation 346/2013 [2013] OJ L115/18. The Commission has consulted on the reforms needed to strengthen the capacity of these funds to support fund raising: *Commission, Consultation Document. Review of the European Venture Capital Funds and European Social Entrepreneurship Funds Regulations (2015)*.

development and diversification of the supply of funding, including through reforms to the EU's harmonized fund management regulation regimes, notably the 2015 European Long Term Investment Fund structure (the ELTIF);[15] the encouragement of stronger household/retail investment in the financial markets (a Green Paper on Retail Financial Services has been issued[16]); and the improvement of market effectiveness, including by means of enhancements to current EU supervisory arrangements, improvements to market data consolidation mechanisms, reforms to EU market infrastructure and securities law, and reforms to company law, corporate governance requirements, insolvency law, and taxation.[17]

The CMU agenda is something of a hodge-podge of the mundane and the aspirational, the specific and the general, the short term and the long term. But its ambition is transformative. Its seeks to strengthen the fund-raising capacity of the single EU capital market; to increase and diversify of sources of funding in the EU beyond the currently dominant bank funding channel; and to achieve a more efficient and effective EU capital market.

*A Pivotal Moment for EU Financial System Governance?*

Why is yet another EU financial system governance reform agenda worthy of comment? Unsurprisingly given its promise of some deregulation and of regulatory intervention

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[15] Regulation 2015/760 [2015] OJ L123/98.

[16] *Commission, Green Paper on Retail Financial Services COM (2015) 630 final*.

[17] *Commission CMU Action Plan*, pp. 7-27.

targeted to facilitating funding (notably the securitization reforms), and its focus on markets as productive drivers of growth, CMU has had powerful traction with a battle-weary and beleaguered financial industry.[18] Although a Commission initiative, it has also garnered significant institutional support,[19] including from the important summer 2015 "Five Presidents' Report" on Economic and Monetary Union (EMU).[20] It has also enjoyed political backing, notably in the UK[21] which stands to benefit from the reforms given the pivotal position of the City of London in the EU capital market.

But to what extent does the CMU project represent a potentially innovative or disruptive change to EU financial system governance? As considered further below, the CMU project can be regarded as simply another incremental step along an EU reform path

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[18] Major supportive reviews include *European IPO Task Force, Rebuilding IPOs in Europe. Creating Jobs and Growth in European Capital Markets (2015).* Some 306 industry respondents relied to the initial Green Paper consultation; overall, responses were described by the Commission as "universally supportive" (*Commission CMU Action Plan*, p. 4).

[19] The ECOFIN Council (*Conclusions on the Commission Action Plan on Building a Capital Markets Union, Press Release 79/15, 10 November 2015*), European Parliament (*Resolution on Building a Capital Markets Union, B8-0655/2015, 1 July 2015*), and ECB (*Building a Capital Markets Union – Eurosystem Contribution to the European Commission's Green Paper (2015*)) are broadly supportive.

[20] *Completing Europe's Economic and Monetary Union. Report by Jean-Claude Juncker, in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi, and Martin Schulz (2015*), p. 12.

[21] See e.g. *House of Lords, European Union Committee, 11th Report of Session 2014-2015, Capital Markets Union: a welcome start (2015*).

which was originally laid out in 1966 with the Segré Report on capital market funding.[22] But the CMU agenda is more important to EU financial system governance than its incremental character and its relatively thin current content might suggest. It may have importance implications for the future organization of EU financial system governance and whether it becomes more centralized or fragmented; the evolution of institutional governance; the evolution of regulatory governance, particularly with respect to regulatory innovation; and the structure of the EU funding market.

First, the CMU agenda and its execution is likely to shed light on the extent to which EU financial system governance is on a path towards multi-speed organization or, alternatively, towards cohesion, and on the related political dynamics.[23] The crisis era led to the single EU financial system being governed by a harmonized "single rule-book" of massive scale and depth and being supported by a new institutional structure in the form of the European System of Financial Supervision (ESFS).[24] But the crisis era also

[22] *Report by a Group of Experts Appointed by the EEC Commission, The Development of a European Capital Market (1966*).

[23] For a recent assessment of the impact of political interests on financial governance see *F. Partnoy, "Financial Systems, Crises, and Regulation" in N. Moloney, E. Ferran, and J. Payne, (eds), The Oxford Handbook of Financial Regulation (Oxford University Press, 2015), pp. 68 - 93*.

[24] The ESFS is composed of: the Member States' national supervisors which provide the foundations of the system; the three sectoral European Supervisory Authorities - the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and their co-ordinating Joint Committee; and the European Systemic Risk Board (ESRB), which is charged with monitoring pan-EU system-wide risks and macro-prudential stability.

opened up the first major breach in the single financial system in the form of Banking Union. The supervision and rescue/resolution of Banking Union's banks now takes place within the Single Supervisory Mechanism and the Single Resolution Mechanism; outside Banking Union, these functions are held at national level, albeit coordinated within the ESFS. This breach may be widened, with existential implications for the single financial system, by the CMU project, particularly if the CMU project becomes accelerated by or enmeshed within a related, euro-area-located "Financial Union."

Unlike Banking Union which is primarily a euro-area project (it is mandatory for euro-area Member States although other "participating Member States" may join), CMU is a single market project. The CMU agenda is, in part, designed to protect the single market against both the centralizing centripetal forces and the countervailing and fragmenting centrifugal forces which may be unleashed by the euro-area Banking Union. But, and in a revealing indication of how these effects might develop, the June 2015 Five President's Report on Economic and Monetary Union (EMU) makes clear that CMU could have strong centralizing effects (and, at the same time, fragmenting effects) in that it could be co-opted by the euro area to form part of a new "Financial Union" - composed of Banking Union and CMU – which is essential to complete EMU.

The Five Presidents' Report calls for an "Economic Union" and (in the more long-term) a "Fiscal Union" to complete EMU and sets out high-level reform proposals and time-lines in this regard. But it also calls for a "Financial Union" and highlights that "Economic and Financial Union are complementary and mutually reinforcing….Progress on these two fronts must be a top priority."[25] The nature of this Financial Union is currently opaque. Banking Union seems to be at its core. But Financial Union is also characterized by the Five Presidents' Report as including the single-market-oriented CMU as a means for allowing it to "diversify risks across countries, so [Financial Union] can moderate the impact of cross-country shocks" and ensure that monetary policy decisions are transmitted across EMU.[26] The ECOFIN Council has similarly suggested that the achievement of CMU is a priority for completing EMU.[27]

Execution of the CMU agenda is accordingly likely to see a complex feedback loop develop with respect to EU financial system governance between the euro area (which has distinct interests, having committed to risk mutualization, burden-sharing, and centralized supervision through Banking Union and its institutional structures), and the single financial market (which is less centralized and where interests are more diffuse, and the legal infrastructure for which is primarily concerned with market liberalization and related supervisory coordination and which organizes supervision and resolution/rescue at national level, albeit coordinated through the network-based ESFS).[28]

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[25] *Five Presidents' Report*, p. 11.

[26] *Five Presidents' Report*, p. 11.

[27] *November 2015 Council Conclusions*, para. 4.

[28] On the changing and fragmenting political economy of EU financial governance see *D. Howarth and L. Quaglia, "The Comparative Political Economy of Basel III in Europe", Europa Working Paper No 2015/03, available at http://ssrn.com/abstract=2630555* and D. Howarth and L. Quaglia, "Banking Union as Holy Grail: Rebuilding the Single Market in Financial Services, Stabilizing Europe's Banks, and 'Completing' Economic and Monetary Union" (2013) 51 Journal of Common Market Studies 103.

The implications for the governance design of the single EU financial market and for the integrity of the single market may be significant. With respect to regulatory governance, there are already indications of a relatively strong euro-area institutional interest in more intense levels of harmonization across a wide field of CMU-related measures (including taxation, company, and insolvency law – all currently primarily a function of domestic law).[29] Whether or not this institutional support reflects political support across the euro area is not clear: the extent of political support for further harmonization is likely to reflect myriad influences, including euro-area familiarity with the Banking Union structures and closer convergence between the financial systems of certain euro-area Member States, should this be achieved. Coalitions of euro-area Member States are likely to be unstable, however, forming and re-forming depending on the particular issues at stake. But there is at least the potential for a rift to open between the euro area and other Member States with respect to the appropriate level of CMU-led harmonization for the single market, the influence of the euro area on the design of CMU, and, ultimately, whether a more intense form of CMU regulatory governance should be constructed for a "Financial Union."

[29] e.g. *Five Presidents' Report, p. 12* (calling for a wide range of reforms, including with respect to taxation), and Panel Remarks by Yves Mersch, Member of the ECB Executive Board, Eurofi Conference, 10 September 2015. Similarly, Bank of England Governor Mark Carney has suggested that specific provisions with respect to prudential regulation may be required for Banking Union Member States (as recognized by the February 2016 New Settlement): Letter from Bank of England Governor Carney to Treasury Select Committee Chair Tyrie, 7 March 2016, pp. 7-8.

Assuming that on 23 June 2016 the UK decides to remain a member of the EU, any euro-area/Financial-Union-inspired re-characterization of the CMU project would be shaped by the European Council's 18-19 February 2016 Decision on a "New Settlement" for the UK within the EU. With respect to financial system governance, the New Settlement is primarily concerned with confirming the current allocation of competence with respect to financial stability matters and with reinforcing the primacy of national supervisors/Member States (outside Banking Union/the euro area) in this regard. But it has implications for the development of the CMU reform agenda.

The New Settlement Decision includes principles governing "the effective management of the banking union" and "the consequences of further integration of the euro area."[30] The New Settlement in this regard seeks to respond to UK calls (fueled in particular by Banking Union) for reforms to protect UK and single market interests against the risk of euro area/Banking Union caucusing,[31] and to reflect, at the same time, the concern of the Commission and of euro-area Member States, notably France, that the UK not be permitted to avoid the single rule-book and thereby to protect its financial sector.[32] The

[30] Decision of the Heads of State or Government Meeting Within the European Council, Concerning a New Settlement for the United Kingdom with the European Union, European Council Meeting, 18 and 19 February 2016 EUCO 1/16 (Annex 1). The relevant principles are set out in Section A, Economic Governance. The Decision takes effect only if the UK decides to remain a member of the EU.

[31] The UK's related renegotiation demands were set out in a Letter from UK Prime Minister Cameron to European Council Chair Tusk, 10 November 2015, p. 2.

[32] France was reportedly against any concessions which would have conferred on the UK a de facto veto on financial regulation: e.g. J. Brunsden and A Barker, "Brexit deal: would City safeguards have stopped

heavily hedged and carefully nuanced set of related principles, which are designed, inter alia, to be "an instrument for the interpretation of the Treaties," in many respects re-state established principles, such as the prohibition on discrimination on grounds of currency.[33] The New Settlement Decision also, however, addresses current tensions with respect to control of financial-stability-related measures by highlighting and reinforcing the current position with respect to financial stability and supervisory governance: competence with respect to macro-prudential responsibilities, and the supervision and resolution of financial institutions and markets, is declared to lie at national level, for non-euro-area Member States.[34] The Decision similarly seeks to address concerns that euro-area/Banking Union caucusing could influence the single-market-wide single rule-book. In particular, it acknowledges some potential for differential application, by providing that the single rule-book, the monolithic nature of which has been something of an article of faith since the crisis era, "may need to be conceived in a more uniform manner" by the ECB within Banking Union's Single Supervisory Mechanism, by the Single Resolution Board within the Single Resolution Mechanism, or by "Union bodies exercising similar functions" (likely a reference to the European Supervisory Authorities) in relation to Banking Union banks.[35] But while it reinforces (politically at least) the

bonus cap", *Financial Times* 3 February 2016 and A. Barker and G. Parker, "Cameron 'in good place' for Brussels deal", *Financial Times*, 18 February 2016.

[33] European Council Decision, Section A Economic Governance, para. 1. The principle acknowledges, however, that differences of treatment are possible, although they must be based on "objective reasons."

[34] European Council Decision, Section A Economic Governance, para. 4.

[35] European Council Decision, Section A Economic Governance, para. 2. This provision is somewhat Delphic, particularly as the need for consistent pan-EU application of the single rule-book has been a

distinct competence of non-euro-area Member States, and seeks to immunize the single rule-book from distinct euro area/Banking Union needs, the New Settlement Decision also signals that further integration of financial system governance, beyond Banking Union, may take place within EMU. The New Settlement Decision states that "further deepening" is needed to establish EMU, that the EU institutions and Member States are to "facilitate coexistence between different perspectives," and that non-euro-area Member States are not to impede the implementation of legal acts "directly linked to the functioning of the euro area."[36] Assuming that a euro-area "Financial Union" can be regarded as being "directly linked" to EMU (the nature of the required linkage to EMU, which requirement re-appears across the relevant principles, is not specified), a multi-speed CMU cannot accordingly be ruled out, politically at least.

There are, however, braking factors which may act as frictions which obstruct CMU-driven fragmentation of EU financial system governance. The principles set out in the New Settlement Decision provide that the integrity of the internal market must be respected and that legal acts "directly relating to the functioning of the euro area" (which might, depending on how the Financial Union aspiration develops, include some CMU-related measures) must respect the internal market. In addition, a political brake has been

defining feature of political, institutional, and policy discourse since the outbreak of the financial crisis. This provision has, for example, been interpreted as implying that relevant single rule-book rules take the form of Directives for non-euro-area Member States (thus allowing these Member States to adopt higher standards where appropriate) and maximum harmonization Regulations for euro area/Banking Union Member States: Letter from Bank of England Governor Carney to Treasury Select Committee Chair Tyrie, 7 March 2016, pp. 7-8.

[36] European Council Decision, Section A Economic Governance, opening para. 2.

made available which allows one or more Member States which do not participate in Banking Union to require further Council (and European Council) discussion on such euro-area related measures (the scope of the brake is not entirely clear).[37] More generally, while the New Settlement Decision suggests that the single rule-book may be interpreted in a more uniform manner for Banking Union banks, its principles also reinforce the overall primacy of the internal market's single rule-book, stating that EU credit institutions and financial institutions are subject to the single rule-book, and noting that the competence of non-euro area Member States with respect to financial stability measures is without prejudice to the development of the single rule-book.[38]

It remains to be seen whether regulatory governance for CMU will take the form of the traditional, pan-EU single rule-book or will alternatively follow a more differentiated model with distinct euro area and non-euro-area components: political, institutional, and market conditions will be determinative. It is, however, clear from the New Settlement Decision that the potential for differentiated integration with respect to financial system governance is now accepted politically, and that a decision-making mechanism (in the form of the political brake for Member States not participating in Banking Union) will apply. Multi-speed approaches may also appear with respect to CMU supervisory governance, as is also implicit in the New Settlement's affirmation of respective national/Banking Union competences with respect to financial stability. However it develops, the evolution of CMU will prove revealing as to the future direction of EU

[37] Draft Council Decision, annexed to Section A of the European Council Decision (Annex II).

[38] European Council Decision, Section A Economic Governance, paras. 2 and 4.

financial system governance – as well as of the impact of the February 2016 New Settlement.

Second, the institutional governance implications of the CMU project for EU financial system governance, and for the ESFS in particular, may be significant.[39] The three still-youthful European Supervisory Authorities (ESAs), constructed in the white heat of crisis over 2010-2011 and charged with an array of supervisory convergence, quasi-regulatory, and (limited) direct supervisory and enforcement functions within the ESFS, reached their fifth birthdays in January 2016. The recent 2013-2014 Commission ESA Review has not called for radical reforms.[40] But the institutional structures of EU financial system governance have long been associated with dynamism and momentum[41] and the ESAs form part of an increasingly dynamic and unstable institutional eco-system. In particular, the extent to which the Banking Union reforms, and notably the Single Supervisory Mechanism and Single Resolution Mechanism, will exert destructive forces (whether centripetal or centrifugal) on the single-market-wide ESFS is not clear. In this unstable environment the CMU agenda is likely to act as an additional and de-stabilizing agent of change. In particular, it has the potential to change the operating environment and

[39] See further N. Moloney, "Institutional Governance and Capital Markets Union: Incrementalism or a 'Big Bang'?" (2016) European Company and Financial Law Review, forthcoming.

[40] *Commission, Report on the Operation of the European Supervisory Authorities and the European System of Financial Supervision COM (2014) 509 final*. A subsequent White Paper on reform is expected by June 2016.

[41] See further *Moloney, EU Securities and Financial Markets Regulation, Ch. XI.*

incentives of the European Securities and Markets Authority (ESMA), the ESA most engaged with CMU.

Third, the CMU project may generate regulatory innovation.[42] It can reasonably be suggested that future regulatory innovations in EU financial system governance will be independent of the CMU agenda and, in particular, a function of the upcoming review period over which the massive crisis-era single rule-book will be reviewed. EU financial system regulation has entered a critical phase during which close attention will be trained on the crisis-era reforms. Regulatory design flaws[43] and application problems (including

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[42] Regulatory innovation can be associated with three forms of change. These are: first-level changes to the settings of regulation – technical changes to rules and practices which do not change the regulatory status quo and which might not be associated with innovation, although the cumulative effect may be innovative; second-level changes to institutional structures and to the nature of intervention – changes to the mix of hard and soft law deployed by regulators, for example; and third-level changes to the cognitive or normative nature of regulation, leading to, for example, a resetting of the policy goals of regulation: J. Black, "What is Regulatory Innovation" in *J. Black, M. Lodge, and M. Thatcher (eds), Regulatory Innovation. A Comparative Analysis (Elgar, 2005*), pp. 9-11. Elements of all three forms of innovation can be found in the CMU agenda which is concerned with technical change (first order), with stronger reliance on non-regulatory instruments (second order), and with growth as a more prominent policy goal of EU financial regulation (third order).

[43] Including with respect to the cornerstone Capital Requirements Directive 2013/36/EU [2013] OJ L176/338 (CRD IV) and Regulation 575/2013 [2013] OJ L176/1 (CRR) which accommodates significant national divergence from the new capital rules (*Basel Committee, Regulatory Consistency Assessment Programme (RCAP), Assessment of Basel III Regulation – European Union, December 2014*); and in relation to inconsistencies between key definitions across the crisis-era reforms: e.g., *House of Lords,*

with respect to proportionate application[44]) are emerging. A major Commission review of the crisis-era reforms is underway,[45] while the Commission has also begun the process of examining the real economy impact of the reform programme.[46] The individual review clauses which mandate reviews of the key crisis-era measures are being activated.[47] Close

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*European Union Committee, Fifth Report of Session 2014-2015, The Post-Crisis EU Regulatory Framework: do the pieces fit? (2015), pp. 52-54*.

[44] As revealed by the controversy which attended the European Banking Authority's (EBA) adoption of Guidelines on the highly-contested CRD IV/CRR remuneration/bank bonus rules and the related sharp divergences across national bank supervisors as to whether a proportionate application of the rules implied the dis-application of the rules or simply their calibration: *EBA, Consultation on Draft Guidelines on Sound Remuneration Policies (2015) (EBA/CP/2015)/03*). The final Guidelines were adopted in December 2015 (EBA/GL/2015/22), but the UK's Prudential Regulation Authority and Financial Conduct Authority have announced their intention not to comply with an element of the Guidelines relating to the application of the bonus cap rule to smaller institutions, given their view that proportionate application implies dis-application: Bank of England, News Release, 29 February 2016.

[45] *Commission, Call for Evidence, EU Regulatory Framework for Financial Services (2015).*

[46] e.g. the Commission's July 2015 consultation on the impact of the new prudential rules on bank-based funding: *Commission, DG FISMA Consultation Paper on the Possible Impact of the CRR and CRD IV on Banking Financing of the Economy (2015*). For an initial, more high-level general assessment see *Commission, A Reformed Financial Sector for Europe COM (2014) 279 final* and its accompanying Staff Working Document (*Commission, Economic Review of the Financial Regulation Agenda (2014) SWD (2014) 158*).

[47] The important review of the pivotal 2012 European Market Infrastructure Regulation (EMIR) (Regulation 648/2012 [2012] OJ L201/1) which reforms OTC derivatives market regulation, e.g., was recently launched: *Commission, Public Consultation on Regulation EU No 648/2012 (2015*).

institutional, political, and market attention to this review process can be predicted.[48] Any future regulatory innovation in EU financial system governance might accordingly take the form of related calibrations to existing rules, such as proportionality-related reforms. They might also take the form of procedural/institutional reforms, such as mechanisms which support the finessing and correction of the single rule-book. Nonetheless, the CMU project represents the first major regulatory initiative for the EU financial system in the wake of the financial and euro-area crises. It may therefore generate distinct regulatory innovations. The CMU project is also likely to be revealing as to whether and how the EU's approach to financial system intervention has changed after the crisis-era period of intense reform. In particular, the CMU project is likely to reveal the extent of the EU's regulatory capacity to recalibrate regulation, where necessary, to support growth – a difficult exercise.[49]

Fourth and finally, the market prize may be significant. Reflecting a global concern with the productive capacity of the financial system,[50] the CMU project is designed to "unlock

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[48] As is clear from the European Parliament's recent Balz Resolution (*European Parliament, Stocktaking and Challenges of EU Financial Services Regulation, 19 January 2016 (P8_TA(2015)0268) (Balz Resolution*).

[49] In the context of the 2012 US JOBS Act – regarded as the most significant deregulation of the disclosure-based securities regulation system which governs access to the capital markets in the US – see D. Langevoort and R. Thompson, "Publicness in Contemporary Securities Regulation after the JOBS Act" (2013) 101 Georgetown Law Journal 337

[50] The institutions of global financial governance are concerned e.g. with how "simple" securitizations which support funding might be identified and supported: *Basel Committee and IOSCO, Criteria for*

investment in Europe's companies and infrastructure" by building a "true single market in capital." [51] Ambitiously, this single market in capital should complement banks as the predominant source of funding in the EU; unlock more investment for all companies (but particularly SMEs) and for long-term infrastructure investments; attract more investment into the EU from the rest of the world; and make the EU financial system more stable by opening up a wider range of funding sources.[52]

While there are indications of a return to financial stability,[53] after some eight years of market convulsions and disruptive reforms the ability of the EU financial system to fund growth is fragile. The capacity of banks to lend into the real economy, and in particular to SMEs and to long-term infrastructure projects – on both of which economic growth depends[54] – has been reduced, in part as a result of the tougher regulatory regime (and in

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*Identifying Simple, Transparent and Comparable Securitisations (2015)* and *Basel Committee, Capital Treatment for 'Simple, Transparent and Comparable' Securitisations: Consultative Document (2015*).

[51] *Commission CMU Green Paper, p. 2*.

[52] *Commission CMU Green Paper*, p. 2.

[53] The swathe of assessments from 2015 suggest that the EU financial system is stabilizing and that financial stability risks are reducing (if still significant): *Commission, European Financial Stability and Integration Review April 2015 SWD (2015) 98* and *ECB, Financial Integration in Europe (2015*). In their most recent risk report, however, the ESAs raised their assessment of the level of risk to which the EU financial system is prone: *ESA Joint Committee, Report on Risks and Vulnerabilities in the EU Financial System, August 2015 (JC 2015 053 rev 1).*

[54] SMEs e.g. employ 2 in every 3 employees in the EU: *Commission, Annual Report on European SMEs: A Partial and Fragile Recovery (2014), p. 6*.

particular capital and leverage rules) under which banks now operate.[55] With respect to market-based funding, the ability of major proprietary traders (market makers) to support liquidity in securities (particularly more illiquid securities) and in the risk management products which support market-based funding has been reduced, in part because of more intensive capital and other risk management requirements; there are particular concerns as to the impact of the EU's new market microstructure rules on bond market liquidity,[56] and the implications for capital market funding through the primary bond issuance markets. If capital market funding sources (including investment by wholesale investors and loan origination by investment funds) can, however, be strengthened, the capacity of the EU to fund growth may be significantly enhanced.[57] The capital market funding gap with the US, for example, remains significant: medium-sized US companies receive five times more funding from capital market sources.[58] Comparisons with the US must, of course, be made with caution given the different institutional structure of the US and EU economies. The EU economy also depends on a well-functioning banking system, as the European Parliament has been quick to underline.[59] Nonetheless, greater diversification

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[55] *EBA, Overview of the Potential Implications of Regulatory Measures for Banks' Business Models (2015).*

[56] For a recent assessment see *ICMA (International Capital Markets Association), The Current State and Future Evolution of the European Investment Grade Corporate Bond Secondary Market: Perspectives from the Market, November 2014.*

[57] *N. Anderson, M. Brooke, M. Hume, and M. Kürtösiová, "A European Capital Markets Union: Implications for Growth and Stability" Bank of England Financial Stability Paper No 33 (2015).*

[58] *Commission CMU Green Paper, p. 2.*

[59] *European Parliament, Draft Karas Report on Access to Finance for SMEs and Increasing the Diversity of SME Funding in a Capital Markets Union, 4 February 2016 (PR/1085842EN.doc) (Draft Karas Report*), paras. 8-9.

of funding sources such that an optimal choice of funding channel is available, and that the current correlation between bank funding and the credit and economic cycle is weakened, should strengthen the funding capacity of the EU and its potential for growth.

*Situating CMU*

This article accordingly seeks to chart, critique, and contextualize the main features of CMU, given its importance to EU financial governance more generally. To do so, it draws on a composite literature.

For much of its development the still relatively youthful scholarship on EU financial system regulation has been of either a legal or a functionalist "law and finance" orientation. Legal scholarship has critiqued, for example, who should be the rule-maker for the EU financial system, the role of harmonization, the nature of the constitutional constraints which apply, and the roles and powers of the administrative structures which support EU financial governance.[60] Law and finance analyses have considered, for

[60] For an early example see *R. Buxbaum and K. Hopt, Legal Harmonization and the Business Enterprise (de Gruyter, 1988);* and, in the context of the financial crisis, *Ferran, Crisis-driven Regulatory Reform*, P. Schammo, "The European Securities and Markets Authority: Lifting the Veil on the Allocation of Powers" (2011) 48(6) Common Market Law Review 1879, and N. Moloney, "EU Financial Market Regulation after the Global Financial Crisis: 'More Europe' or More Risks?'" (2010) 47(5) Common Market Law Review 1317.

example, whether EU intervention is likely to have effects on financial development.[61] The CMU agenda provides a rich case-study for analyses of this type as it prompts questions as to whether the proposed regulatory reforms, and the related levels and styles of EU intervention, are effective and can achieve their outcomes.

In addition, the cognate comparative political economy literature sheds sharp light on the power dynamics and the institutional context of the CMU project, and thus sustains predictions of how the project is likely to develop. This literature charts the forces which shape the single EU financial system,[62] including those forces which emanate from the underpinning institutional structures which shape national economies and the related sectoral interests. The impact of shifting political and sectoral industry interests has been closely examined[63] (including with respect to the relative influence of bank- and market-based funding models and of the mixed market-based banking model now increasingly

[61] See e.g. L. Enriques, "EC Company Law Directives and Regulations: How Trivial Are They?" (2006) 27 University of Pennsylvania Journal of International Economic Law 1 and *E. Ferran, Building an EU Securities Market (Cambridge University Press, 2004).*

[62] For reviews see D. Mügge, "The Political Economy of Europeanized Financial Regulation" (2013) 20(3) Journal of European Public Policy 458 and L. Quaglia, "The 'Old' and 'New' Politics of Financial Services Regulation in the EU" (2012) 17(4) New Political Economy 515.

[63] For an influential analysis of EU intergovernmental relations in terms of "market-making" coalitions (which tend to display trust in markets and to favour light-touch regulation) and "market-shaping" coalitions (which tend to show distrust of markets and to favour re-regulation) see L. Quaglia, "Completing the Single Market in Financial Services: the Politics of Competing Advocacy Coalitions" (2010) 17(7) Journal of European Public Policy 1007.

common[64]) along with, for example, the influence of supranational interests,[65] including those of the EU's networked-based regulators.[66] Recent research has, for example, exposed why and how different coalitions of interests over the financial crisis determined the nature and intensity of EU financial system regulation and also shaped the EU's ability to influence international financial governance.[67]

Cognate social science literature additionally sheds light on the "regulatory capacity"[68] of the EU to achieve CMU, particularly given the recent "agencification" of EU financial system governance through the ESAs and the related enhancement of the EU's

[64] *I. Hardie, and D. Howarth, (eds), Market-based Banking and the International Financial Crisis (Oxford University Press, 2013).*

[65] On the role of the Commission in EU financial regulation see *L. Quaglia, Governing Financial Services in the European Union. Banking, Securities, and Post-trading (Routledge, 2010)* and, with reference to the development of the crisis-era reforms, *L. Quaglia, The European Union & Global Financial Regulation (Oxford University Press, 2014).*

[66] e.g. E. Posner, "Making Rules for Global Finance: Transatlantic Regulatory Cooperation at the Turn of the Millennium" (2009) 63(4) International Organization 665 and D. Coen and M. Thatcher, "Network Governance and Multilevel Delegation: European Networks of Regulatory Agencies" (2008) 28 Journal of Public Policy 49.

[67] See D. Mügge, "Europe's Regulatory Role in Post-Crisis Global Finance" (2014) 21(3) Journal of European Public Policy 316.

[68] "Regulatory capacity" from a political science perspective is typically associated with the ability of a state to formulate, monitor, and enforce rules: D. Bach and A. Newman, "The European Regulatory State and Global Public Policy: Micro-institutions, Macro-influence" (2007) 14(6) Journal of European Public Policy 827.

administrative capacity.[69] It also illuminates how the traditional governance tools which the EU has deployed in market construction might change over the CMU project. In particular, the "experimentalist governance" strand of regulatory governance theory has potentially powerful explanatory force with respect to the fluid and iterative means through which the EU might construct CMU.[70]

Drawing on this mosaic of perspectives, this article considers whether the CMU project is likely to have an impact on the EU capital market. Given that the ability of the CMU project to achieve transformative effects may be limited, it then assesses how the risks flowing from the CMU project can be mitigated. The article finally examines how CMU is likely to change regulatory and supervisory governance and whether centrifugal fragmentation effects or centripetal cohesive effects might be generated by the CMU project.

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[69] For a pre-ESFS view see E. Posner, "The Lamfalussy Process: Polyarchic Origins of Networked Financial Rule-making in the EU" in C. Sabel and J. Zeitlin, (eds), *Experimentalist Governance in the European Union. Towards a New Architecture (Oxford University Press, 2010),* pp. 43-60.

[70] On experimentalist governance and EU financial governance see generally *Sabel and Zeitlin, Experimentalist Governance* and M. Campbell-Verduyn and T. Porter, "Experimentalism in European Union and Global Financial Governance: interactions, contrasts, and implications" (2014) 21(3) Journal of European Public Policy 408.

**Capital Markets Union in Context: Transformative Effects and the Role of EU Regulation**

*Market Finance and the EU*

The CMU agenda is concerned with market-based finance. In broad terms, in economies based on market finance non-bank intermediaries (such as investment firms and asset managers) play a significant role in supporting the movement of capital from capital suppliers (including households) to capital seekers (companies) by, for example, intermediating between firms issuing securities and investors providing capital. In economies based on bank finance banks take deposits and make loans and so are the major channel for intermediation between capital suppliers and capital seekers by means of their maturity transformation function (or their provision of loan assets to capital seekers based on the deposit liabilities banks draw from capital suppliers).[71] Mixed funding models, based on market-based funding by banks (including through the securitization of loan assets) are, however, a strong feature of a number of economies, including those of the UK and France in the EU.[72]

EU funding channels are, and have long been, heavily bank-based. Loans (including inter-company and bank loans) represent some 29% of non-financial company (NFC) funds, for example, while corporate bonds represent only 4% or so. Similarly, NFCs

[71] See, e.g, *IMF, Global Financial Stability Report, October 2012, ch. 3 (The Reform Agenda: An Interim Report on Progress towards a Safer Financial System), p. 2*.

[72] D. Howarth and I. Hardie, "Die Krise or La Crise: the Financial Crisis and the Transformation of the German and French Banking Systems" (2009) 47(2) Journal of Common Market Studies 1017.

account for only 7.5% or so of total bonds outstanding in the EU while governments account for some 42.5%.[73] While reliance on equity funding through shares listed on trading venues is stronger (16.2% of NFC funding),[74] equity funding is primarily the province of large NFCs and is very difficult to raise by SMEs (as is bond funding), given in particular SMEs' difficulty in signaling their quality as investments and as information sources on SMEs are limited and non-standardized.[75] By way of contrast, and allowing for the dangers in comparing very different economies and markets, market-based funding is significantly stronger in the US, where the public equity market, for example, is almost double the size of the EU equity market (at 138% and 64.5% of GDP, respectively).[76]

The degree to which an economy relies on bank or market-based funding can have significant implications,[77] although the relative importance of the different funding models for economic development is contested.[78] Very broadly, market finance (and

[73] *Commission, Staff Working Document, Initial Reflections on the Obstacles to the Development of Deep and Integrated EU Capital Markets SWD (2015) 13 final, p. 22*.

[74] *Commission, European Financial Stability and Integration Report, SWD (2015) 98 final, p. 48*.

[75] *Commission Initial Reflections,* pp. 22-28, reporting on the high dependence by SMEs on bank loans and on channels such as trade credit.

[76] *Commission CMU Green Paper, pp. 7-8*.

[77] See e.g. *M. Giovannini, C. Mayer, S. Micossi, C. Di Noia, M. Onado, M. Pagano, and A. Polo, Restarting European Long-term Investment Finance. A Green Paper Discussion Document (CEPR, 2015), pp. 9-17*.

[78] For a key contribution see R. Levine, "Bank-based or market-based Financial Systems: Which is Better?" (2002) 11(4) Journal of Financial Intermediation 398.

particularly equity-based finance) is associated with more flexible financing and with the support of innovation. Banks, by contrast, may have conservative lending policies and, as the financial crisis showed to crippling effect, bank finance is at risk of paralyzing credit squeezes, is closely correlated with the economic cycle (EU SMEs are accordingly acutely vulnerable to funding contractions[79]), and is vulnerable to systemic failures.[80] The financial crisis also underlined, however, the stability risks which markets can generate, and how intense levels of market-based intermediation can create destructive levels of risk and lead to a proliferation of risk transmission channels which can destabilize the financial system. The recent focus by the IMF on the stability risks posed by market finance underscores the risks of market-based finance.[81] But while the financial crisis led to some questioning of the efficacy and role of the public equity markets, in particular, it has not led to a retreat from policy support of the market finance model.[82]

The CMU agenda does not seek to transform the EU economy into a market-funding based economy, reflecting the neutrality view of bank and market-based funding which

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[79] On EU SME funding see *Giovannini et al, Restarting European Long-term Finance, pp. 9-17*.

[80] See e.g. *L. Gambetti and L. Musso, "Loan Supply Shocks and the Business Cycle", ECB WP No 1469 (2012*) and *M. Pagano and S. Langfield, "Bank Bias in Europe: Effects on Systemic Risk and Growth", ECB WP No 1797 (2015).*

[81] *IMF, Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risk April 2015, ch. 3 (The Asset Management Industry and Financial Stability).*

[82] For empirical discussion on the relative merits and risks see L. Gambacorta, J. Yang, and K. Tsatsaronis, "Financial Structure and Growth" (2014) BIS Quarterly Review 2014 and *ECB, The External Financing of Household and non-Household Corporations: a Comparison of the Euro Area and the United States' Monthly Bulletin, April 2009, p. 69*.

posits that both funding models can contribute in different ways according to the stage of development of an economy, and that model imbalances should be avoided.[83] The CMU project is accordingly designed to address the economic risks which an over-dependence on bank funding can generate. It seeks to diversify funding sources, protect the EU economy against a contraction in bank funding, and strengthen the shock-absorbing capacity of the EU economy.[84] The CMU agenda also seeks an integrated capital market which allows market-based funding to flow cross-border without obstructive regulatory or supervisory divergences and which strengthens the capacity of EU funding markets to deliver diversification to capital suppliers and to thereby reduce the cost of capital.[85] The CMU agenda is clear-eyed as to the continued importance of bank funding to the EU economy,[86] but calls for a rebalancing.

*CMU and Transformative Effects: Lessons from History*

Is the CMU agenda likely to achieve the transformative outcomes sought? History may have some lessons here. In some respects there is nothing new in the CMU agenda. It forms part of a reform pathway that stretches back to the path-breaking 1966 Segré

[83] For a recent review of the evidence see *CEPS-EMCI, Europe's Untapped Capital Market: Rethinking Integration after the Great Financial Crisis (CEPS, 2016), pp. 66-70*.

[84] *Commission CMU Green Paper, p. 4.*

[85] *Commission CMU Green Paper, p*. 5. An integrated capital market is typically associated with a single set of rules, equal access, and equal treatment, although more price-based indicators are also used in EU financial market policy: e.g.: *Commission, European Financial Integration Report 2007 SEC (2007) 1690 final, p.* 8.

[86] *Commission CMU Green Paper, p. 4.*

Report, which underlined that economic growth in Europe was dependent on the capital markets and called for intervention. From the early attempts in the late 1970s at detailed harmonization of the rules which govern the disclosures required when companies (issuers of securities) access the capital markets; to the 1985 White Paper era measures which bolted on mutual recognition devices to those detailed harmonization measures; to the major Financial Services Action Plan (FSAP)-era (1999-2005) reforms which saw the EU adopt a new "passporting" regime governing capital-market funding and the related harmonized disclosures required of companies (based on the 2003 Prospectus Directive, the 2004 Transparency Directive, and the 2002 International Accounting Standards Regulation[87]); to the financial-crisis-era reforms which include measures designed to facilitate SMEs in accessing the capital markets[88] – throughout, the EU has deployed regulatory harmonizing measures to facilitate market finance.[89]

In 1995, before the FSAP reforms, the Commission reported on the "feasibility of the creation of a European Capital Market for smaller entrepreneurially managed growing companies."[90] Over the FSAP era, and in the context of the global dotcom equity market

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[87] Directive 2003/71/EC [2003] OJ L345/64, Directive 2004/109/EC [2004] OJ L390/38, as amended by Directive 2013/50/EU [2013] OJ L294/13, and Regulation 1606/2002 [2002] OJ L243/1.

[88] Such as the "SME Growth Market" reforms to trading market regulation contained in the 2014 Markets in Financial Instruments Directive II which are designed to allow certain trading venues to specialize in the admission of SMEs: Directive 2014/65/EU [2014]OJ L173/349, art. 33.

[89] See further *Moloney, EU Securities and Financial Markets Regulation, pp. 48-193*.

[90] *Commission, Communication. Reporting on the feasibility of the creation of a European Capital Market for smaller entrepreneurially managed growing companies COM (95) 498 final.*

collapse, the Commission asserted that "[t]he assessment that market-based financing heralds substantial benefits for European investors and issuers is not overturned by periodic bouts of volatility or occasional market corrections."[91] The Commission's 2005 White Paper on Financial Services, which marked the end of the reforming FSAP period, saw the Commission assert that "financial markets are pivotal for the functioning of modern economies" and that greater integration was associated with more efficient allocation of resources and long-term economic performance.[92] Over the crisis-era (and in particular in the later stages), the role of capital markets in funding the real economy remained an acute Commission concern, clear from its 2013 Green Paper on Long Term Investment Funding.[93] There is therefore a long history of policy support for market finance and for EU harmonized rules to be deployed as a means for promoting market finance in the EU.

The CMU agenda similarly relies on regulatory governance reforms to promote market finance. But the CMU agenda is more extensive than previous market finance reform agendas. It reaches into, for example, fund structures, securitization mechanisms, and the capital and liquidity rules which shape the investment decisions of institutional investors. It also seems to demand significantly heavier lifting of regulatory and related measures than has been required by the political and policy apparatus up to now. The implicit

[91] *Commission, Communication on Upgrading the Investment Services Directive COM (2000) 729* final.

[92] *Commission, White Paper on Financial Services Policy 2005–2010 COM (2005) 629, p. 4.*

[93] The Green Paper queried whether reforms could be adopted to promote the efficiency of bond markets and to address the slowdown in the EU initial public offer (IPO) market: *Commission, Green Paper. Long Term Financing of the European Economy COM (2013) 150/2, pp. 11-12.*

assumption underpinning the 2015 CMU Green Paper is that harmonized regulation can have transformative as opposed to simply facilitative effects. Although claims to modesty abound,[94] the overall implication is clear: regulatory intervention is needed for the purpose of driving necessary market change and, in light of the continued contraction in bank lending capacity, has a degree of urgency.[95]

Allowing for the wider reach of the CMU reforms as compared to earlier policy agendas, what lessons as to the likelihood of the CMU agenda achieving its market outcomes can be drawn from the long history of CMU-style reforms in the EU?

The extent to which EU regulatory measures can be transformative of market finance rather than simply facilitative is still not clear after some fifty years of EU effort. In some respects, the EU's faith in the power of harmonized rules and related single market access devices (such as the Prospectus Directive's "prospectus passport") to drive market outcomes may not be misplaced. The extensive law and finance scholarship suggests that there is a link of some kind between law and strong securities markets.[96] And certainly,

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[94] Commissioner Jonathan Hill (who has charge of CMU) has warned that "there is no single reason, no single lever that I can pull, no silver bullet": *House of Lords Report, p, 14*. Similarly, the Green Paper notes that the CMU agenda will contain "a range of steps, some individually modest, whose impact will be cumulatively significant": *Commission CMU Green Paper, p. 2.*

[95] *Commission CMU Green Paper, p. 4*.

[96] Pre-crisis growth in market finance in the EU has been related to the impact of law and, in particular, to stronger disclosure and insider trading rules: *L. Zingales and R. Rajan, "Banks and Markets - the Changing Character of European Finance", CRSP WP No 546 (2003), available at http://ssrn.com/abstract=389100.*

market finance has strengthened in the EU over the major regulatory reform periods. Total EU stock market capitalization (a useful, if flawed, proxy for the strength of market funding) rose from 22% of GDP in 1992 to 65% in 2013.[97] The decade prior to the financial crisis witnessed particularly strong growth,[98] with levels of debt and equity issuance activity in the EU over this period outstripping US issuance activity.[99] The Commission's 2004 Financial Integration Monitor, for example, reported that market finance had gained in importance, although it also acknowledged that, overall, bank lending (at 109.6% of GDP) remained the predominant source of financing in the (then) EU-15 Member States.[100] By 2007 the ECB's Report on Financial Integration was reporting on a significant increase in market finance opportunities and on the continued development of corporate bond and equity markets.[101] The Commission's 2007 Financial Integration Monitor agreed, reporting strong growth in bond and equity capital markets, with the value of the EU bond market as a proportion of GDP, for example, increasing

[97] *Commission CMU Green Paper, p. 7.*

[98] Between 1996 and 2006 bond issuance doubled and equity market capitalization tripled. Growth in bank assets was also overtaken by growth in bond assets: *J. P. Casey and K. Lannoo, "The MiFID Revolution", ECMI Policy Brief No 3 (2006), p.3.*

[99] *Casey and Lannoo, "The MiFID Revolution", p .3.*

[100] Unquoted shares and other equity represented 31% of total corporate financing: *Commission, Financial Integration Monitor 2004 SEC (2004) 559, p. 3.*

[101] *ECB, Report on Financial Integration (2007), p. 31.*

from 183% in 2004 to 198% in 2007.[102] EU stock market capitalization as a proportion of GDP also rose over 2004-2007,[103] narrowing the still significant gap with the US.[104]

Over the financial crisis, funding patterns changed again. EU initial public offer (IPO) equity markets experienced a significant contraction,[105] but the bond markets, by contrast, performed more strongly over the crisis, with issuance levels increasing. [106] The relative predominance of market and bank finance continues to vary significantly across Member States.[107]

But is regulatory intervention a key independent variable in the expansion and contraction of market finance in the EU? The pre-FSAP evidence underlines that recourse

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[102] *Commission, European Financial Integration Report 2007,* p. 34.

[103] It grew from 71.7% of EU GDP in 2004, to 74%, 92.2%, and 92% in 2005, 2006, and 2007 respectively: World Bank Data, available through http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS.

[104] In 2004, US stock market capitalization as a % of GDP was 128.6%. By 2007 it was 142.9%: World Bank Data, available through http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS.

[105] As is charted across a series of reports over 2008-2014 including: the PWC IPO Watch Europe Surveys, the Commission's annual European Financial Stability and Integration Reviews, and ESMA's Trends, Risks, and Vulnerabilities Reports. For a review of the data see *Moloney, EU Securities and Financial Markets Regulation, pp. 185-192.*

[106] *Commission, 2015 European Financial Stability and Integration Report, p. 21*.

[107] For a recent assessment see *Commission, 2015 European Financial Stability and Integration Report, pp. 51-101*. Some 60% of all bond issuance, e.g., occurs in the UK, France, Germany, and Italy, while the extent to which household financial assets take forms other than deposits or currency varies significantly and reflects for the most part the financial development of the Member States.

by companies to market finance was already intensifying in the absence of intensive EU regulation,[108] while the 2009 CRA Report on the impact of the FSAP generally found that the FSAP issuer disclosure measures (such as the Prospectus Directive) had a "mixed impact" and did not have a clear effect on securities issuance or on admission to trading activity.[109] The multiplicity of determinative factors associated with the pre-crisis intensification of recourse by NFCs to the markets include growth in the institutional investor community, the impact of the euro, innovation in financing techniques (particularly asset securitization); the establishment of new trading venues (particularly the "second-tier" venues which support SMEs and venture capital); technological innovation supporting stronger price formation; and favourable global macro-economic conditions.[110] Conversely, the persistent dominance of bank lending over this period notwithstanding these influences can be related to a swathe of non-regulatory factors, including, in the pre-crisis period, the significantly greater engagement by banks with trading and in securitization activities, which facilitated bank lending.[111] A range of non-regulatory difficulties have also come to be associated with the sluggish equity markets in

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[108] *Ferran, Building an EU Securities Market, pp. 30–38.*

[109] The Report found it difficult to disentangle the impacts of the regime: *CRA, Evaluation of the Economic Impact of the FSAP (2009) pp. 169-183*.

[110] e.g. *ECB, Financial Integration in Europe (2007), p. 31.*

[111] Hardie and Howarth, "Die Krise but not La Crise? The Financial Crisis and the Transformation of German and French Banking Systems" (2009) 47 Journal of Common Market Studies 1017.

the EU generally over the crisis era, and in the UK in particular.[112] The dramatic change in macroeconomic and financial system conditions over the crisis-era and the related impact on market funding channels further underscores the importance of non-regulatory factors. The recent growth in bond market issuance, for example, can be associated with the continued contraction in bank lending, investors' search-for-yield efforts in a low interest environment, and the low cost of issuing longer-term high-yield bonds. And aside from macroeconomic conditions, the extent to which different funding models become embedded in different Member States is shaped by a complex and interdependent range of other variables, political and sectoral.[113]

The CMU agenda represents something of a break from earlier EU market finance efforts in that it extends beyond the demand-side/capital-seeker issuer disclosure and related trading venue measures previously associated with the EU's promotion of market finance. It takes a more holistic approach which pulls together a range of different regulatory techniques, ranging from support of the market infrastructures which facilitate trading to regulatory incentives for capital suppliers.[114] But ultimately the empirical

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[112] Including listing costs, the impact of high frequency trading, the cost of intermediation, and tax discrimination between debt and equity funding: *The Kay Review of Equity Markets and Long-Term Decision Making, Final Report (2012), pp. 25 and 84-87.*

[113] Mügge, "Europe's Regulatory Role" 21(3) *Journal of European Public Policy* (2014) 316.

[114] Commissioner Hill has acknowledged that CMU "will need to be approached from many different angles – securities laws, investment restrictions, tax treatments, insolvency regimes….all issues that we have been grappling within in Europe for decades': Speech to Finance Watch Conference, 4 February 2015.

evidence from the EU experience warns that the role of law in shaping different varieties of finance is contested and is likely limited.

The picture is no less complex with respect to cross-border market finance. Over the FSAP period, evidence of integration in the form of pan-EU capital-raising by companies, stronger portfolio diversification by investors, a loosening of the entrenched "home bias," and a narrowing of price dispersion in asset classes[115] began to emerge.[116] In 2009, before the effects of the crisis had taken root, the Commission could report on a "remarkable" degree of integration in EU wholesale bond markets, as well as on good, if less intense, levels of integration in the equity markets.[117] Over the financial crisis, however, significant retrenchment took place, with the ECB reporting on a "slow erosion" of progress towards integration, including in the previously highly-integrated bond markets.[118] As has been repeatedly highlighted in CMU discussions, it became clear that cross-border bond markets were frothy and driven by wholesale transactions between financial institutions rather than by real economy funding transactions; once the crisis hit, this activity evaporated.[119] Over 2013 and 2014, however, a reduction in EU bond market

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[115] This variable for integration assesses the extent to which common factors impact on the price of assets.

[116] e.g. *Commission, Financial Integration Monitor 2004, pp. 7–8*.

[117] *Commission, European Financial Integration Report SEC (2009) 19, p.7.*

[118] *ECB, Financial Integration in Europe (2012), pp. 9 and 24-25* and *ECB, Financial Integration in Europe (2013), p. 10.*

[119] As underlined by the Commission: *Commission CMU Green Paper, p.* 8.

fragmentation was reported.[120] Equity market integration was less heavily impacted by the financial crisis; EU equity markets tend to display lower levels of cross-border price differentiation[121] and relatively stable levels of cross-border investment, in particular by euro area investors.[122] But pan-EU public offers remain rare. The extent to which harmonized EU rules have driven integration remains unclear given the range of factors which drive the timing and structure of offerings and cross-border investment patterns and incentives. While, for example, the standardization of disclosure and financial reporting regimes facilitates cross-border funding, it is only one of a range of determinative factors.[123]

Where does this experience leave the CMU project and its transformative effects? Certainly, it cautions against relying too heavily on reforms to the EU's extensive and long-standing issuer disclosure and financial reporting regimes as means for driving change. The risks which the proposed reforms to the Prospectus Directive and to financial reporting may generate may accordingly be overly costly, as outlined in the next section.

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[120] *ECB, Financial Integration in Europe (2014), p. 24*, noting "slightly receding" fragmentation in corporate bond markets in 2013 and *ECB, Financial Integration in Europe (2015*) noting that the degree of fragmentation was diminishing (at p. 22).

[121] *ECB, Financial Integration in Europe (2013), p. 10* and *ECB, Financial Integration in Europe (2015) p. 24*.

[122] *ECB, Financial Integration in Europe (2015), p. 25.*

[123] *Centre for Strategy & Evaluation Services, Study on the Impact of the Prospectus Regime on EU Financial Markets. Final Report (*2008), p. 20.

Experience also cautions against over optimism as to the extent to which the more ambitious CMU regulatory reforms might drive change. The securitization reforms, which are directed to facilitating funding-oriented securitizations, and not to the highly complex and opaque securitizations associated with destructive risk transmission over the financial crisis, represent a new channel for the regulatory promotion of market finance by the EU. If a more facilitative regulatory regime can be designed for "simple, transparent, and standardized" securitizations, banks may have stronger incentives to securitize loan assets and thereby to free up their balance sheets for additional lending. Wholesale investors (the target of the reforms), benefiting from a more standardized regime with lower costs, may have stronger incentives to purchase these assets. A major obstacle to lending to SMEs could accordingly be removed if SME loan securitization is thereby strengthened. But even pre-crisis the SME securitization market was small, and it is not clear whether regulatory reform alone will support the generation of the €20 billion of additional funding which the Commission predicts.[124] A host of challenges are associated with SME securitization, including with respect to poor and non-standardized credit data and to low yields on loan assets,[125] which are not easily addressed by harmonized regulation. The extent to which securitizations can be standardized, and risks to investors more clearly signaled and/or reduced, in the absence of a harmonized, or part harmonized, EU insolvency law, is also not clear.

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[124] *Commission CMU Action Plan, p. 4*. The ECB is also constructing a new database ("AnaCredit") on corporate loans which is predicted to improve transparency on SME credit quality.

[125] *National Institute of Economic and Social Research (A. Armstrong and M. Ebell), Research Report for the British Business Bank on Small and Medium Sized Enterprise Securitisation (2014).*

Efforts to apply lighter regulatory regimes to SMEs in order to ease their direct access to market-based funding may similarly prove to have little traction, given the limited recourse in practice by such firms to the markets and their dependence on bank lending. Potential direct SME investors also face significant difficulties. The patchy, limited, and non-standardized quality of credit data on SMEs, who do not report their financial information under the standardized International Financial Reporting Standards regime, remains a major obstacle to direct investment (and to related securitizations of SME loan assets). While efforts to improve access to SME credit data form part of the CMU agenda,[126] progress is likely to be slow, and banks have few incentives to open up their generally well-developed SME credit databases to the market.

Similarly, the EU investment funds market remains highly fragmented, which limits the potential for economies of scale and for risk management efficiencies, despite years of EU regulatory reform, notably under the "UCITS" funds regime. Recent efforts to strengthen the ability of funds to supply venture capital (notably through the 2013 EUVECA fund structure) are already faltering,[127] while the 2015 ELTIF fund structure for long term investment is also under early review.[128] While regulatory enhancements can be made (particularly with respect to the current strict asset allocation limits imposed

[126] *Commission CMU Action Plan, pp. 9-10.*

[127] *Commission EUVECA Consultation.*

[128] *Commission CMU Action Plan, p. 10.*

on EUVECAs and ELTIFs and with respect to loan origination by funds[129]), it is not clear that the CMU project, through additional regulatory intervention, can significantly deepen and strengthen the fund investor base.

The uncertainty extends beyond regulation to tax policy (assuming the EU could coordinate change in this area). For example, while a removal of the tax advantage enjoyed by debt over equity (interest payments on debt instruments are tax deductible) has been mooted as a means for driving stronger EU equity markets,[130] the US tax rate applicable to equity is one of the highest although the US equity market is the world's strongest.[131]

The achievement of CMU is likely to depend on the smooth interaction of a host of moving parts. These include but are not limited to harmonized regulatory measures: the frictions generated by non-regulatory obstacles are considerable.[132] Regulation may well have a facilitative function, but it is not clear that it will be transformative. Much depends

[129] *Commission CMU Action Plan, p. 10.* The volume of transactions by loan-originating funds increased by 43% between 2013 and 2014 (at p. 10). Ireland e.g. has introduced a new funds regime which supports loan origination by eligible funds.

[130] The Commission has committed to examining how the current debt-equity bias in taxation can be addressed through its work on the Common Consolidated Corporate Tax Basis: *Commission CMU Action Plan, p. 14.*

[131] *Anderson et al., European Capital Markets Union*.

[132] The Commission has noted that the obstacles to capital market construction and integration include historical, cultural and economic factors (as well as legal factors) which are deep-rooted and difficult to overcome: *Commission CMU Green Paper, p. 9.*

on the EU's regulatory capacity to design reforms in such a way that the likelihood of optimal reforms is maximized and that regulatory design risks and unintended consequences are minimized, as discussed in the following section.

## CMU and EU Financial Market Regulation: A Test Case for the EU's Post Crisis Regulatory Capacity

### *Legislative and Administrative Challenges*

The many legacy effects of the financial crisis era on EU financial system governance include the EU's significantly-enhanced regulatory capacity. Leaving to one side the inevitable bouts of political grandstanding over the crisis reform period and the related poor regulatory design outcomes,[133] the co-legislators and the Commission have emerged from this period with, for the most part, enhanced reputations as experienced financial legislators.[134] With respect to administrative rule-making, the technical capacity of the EU has been significantly strengthened by the ESAs, which support administrative rule-making by the Commission by providing Technical Advice and by proposing Binding Technical Standards (a form of level 2 administrative rule).[135] In principle, the EU should

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[133] Associated in particular with the Alternative Investment Fund Managers Directive (Directive 2011/61/EU [2011] OJ L174/11, the CRD IV/CRR "bank bonus" rules, and the Financial Transaction Tax.

[134] See Ferran, *"Where in the World is the EU Going?".*

[135] On the ESAs' role in administrative rule-making see *Moloney, EU Securities and Financial Markets Regulation, pp. 907-941*. The enhancements which the ESAs have brought to administrative rule-making have been widely welcomed: e.g. *Commission, Report from the Commission to the European Parliament and Council on the Operation of the European Supervisory Authorities and the European System of*

be well-equipped to pursue the CMU agenda in an optimal manner and to manage its risks.

These risks include, first, whether the EU can manage complex and competing objectives. Over the financial crisis, EU intervention was broadly directed to the support of financial stability and was framed by the G20's reform agenda. With the CMU agenda, EU intervention is displaying signs of "third order" regulatory innovation[136] by becoming more strongly associated with the support of growth. This shift brings complex regulatory balancing challenges. There is, for example, a tension between the pursuit by the CMU agenda of stronger capital market funding, and the danger that stability risks are thereby increased.[137] Independently of but almost contemporaneously with the 2015 CMU Green Paper and subsequent Action Plan, the institutions of global financial governance have become increasingly concerned with the stability risks posed by capital markets and by market-based funding.[138] The EU has, however, an enhanced institutional

*Financial Supervision COM (2014) 509, final pp. 5-6*; and *IMF, Technical Note on ESMA, IMF Country Report No 13/69, pp. 22-23*.

[136] See note 42 on regulatory innovation.

[137] As has been acknowledged by the Commission: *Commission CMU Action Plan, p. 4.*

[138] The Financial Stability Board's April 2015 Communication to the G20 Finance Ministers and Central Bank Governors e.g. identified the threat of stability risks from market-based finance and announced related work streams: Financial Stability Board (FSB) Chairman Letter to G20 Finance Ministers and Central Bank Governors, Financial Reforms, Progress on the Work Plan for the Antalya Summit, 9 April 2015. Subsequently, in its November 2015 Letter to the G20, the FSB noted that the structure of financial markets had changed since the financial crisis with the growing importance of market-based finance and highlighted that while this development had the potential to make the financial system more diversified, it

capacity post crisis for addressing design challenges of this nature. ESMA, for example, has been quick to reinforce the need to ensure investor protection and to promote stable markets as the CMU agenda progresses.[139] It has also highlighted the capacity it brings to EU financial system governance with respect to risk assessment.[140] The ECB, in its capacity as Banking Union's powerful Single Supervisory Mechanism supervisor, has similarly underlined the need to monitor and manage the potential new risks to financial stability and is well-equipped to do so.[141] The EU also has stronger administrative capacity, through ESMA in particular, to engage with the nascent international standard-setting process on management of the risks of market-based funding (the international standard-setters are beginning to address the stability risks of capital markets and of

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brought new risks: FSB Chairman Letter to G20 Leaders, Financial Reforms – Achieving and Sustaining Resilience for All, 9 November 2015. The FSB remains concerned as to these risks: FSB, Letter to G20 Finance Ministers and Central Bank Governors, 22 February 2016, pp. 2-3.

[139] ESMA Board of Supervisors Minutes, 19 March 2015 (2015/BS/59), warning that these objectives must not be lost sight of under CMU.

[140] *ESMA, Response to the Commission Green Paper on Building a Capital Markets Union (2015) (2015/ESMA/856), p. 4*.

[141] *ECB, Building a Capital Markets Union), p.3.* The Bank of England, the counterweight to the ECB outside Banking Union, has raised similar concerns: *Bank of England, Response to the European Commission Green Paper: Building a Capital Markets Union (2015), p. 2*.

market-based funding[142]) and to calibrate EU regulatory and supervisory governance accordingly.[143]

Second, a host of risks to rule-making quality arise from the "first-order" technical regulatory innovations which will follow under the CMU agenda. The CMU agenda generates, for example, the risk of spill-over and unintended effects from regulatory perimeter redesigns. To take one example, the "regulated market" regulatory perimeter[144] is one of the most important regulatory devices in EU capital market regulation for delineating the scope of regulation. Companies whose securities are admitted to trading on regulated markets are, under the single rule-book, subject to the most stringent levels of disclosure and distinct admission to trading requirements apply. Other trading venues (multilateral trading facilities (MTFs), often termed second tier or alternative venues) are subject to a lighter EU regime and are broadly self-regulating. This distinction reflects the well-established principle that trading venues should be empowered through the regulatory system to compete with respect to their different venue products and, accordingly, to provide specialized venues; these venues may offer lighter regulatory regimes for companies at an earlier stage of development but can also signal to investors

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[142] e.g *FSB and IOSCO, Assessment Methodologies for Identifying non-bank, non-insurer Global Systemically Significant Financial Institutions. Second Consultation (2015*).

[143] See N. Moloney, "The EU in International Financial Governance" forthcoming, Russell Sage Journal of Social Science (2016).

[144] Eligible trading venues opt in to regulated market status (and can have incentives to do so given the related signalling effects as to the quality of the trading venue), which brings with it a host of regulatory obligations under EU financial regulation.

that risks can be higher. Companies can accordingly proceed through a "funding escalator" which conveys them from more lightly regulated venues with specialized investor interest to the heavily regulated and highly liquid "regulated markets" in which retail investors are often active and which act as price-setting venues for trading generally.[145]

The CMU agenda may lead to the distinction between regulated markets and MTFs becoming blurred. The CMU Action Plan identifies MTFs as a vital element in the funding escalator for high-growth mid-sized companies and SMEs generally and calls for related regulatory costs to be reduced.[146] The 2015 Prospectus Regulation Proposal, in an effort to reduce the costs borne by SMEs and to support the new MiFID II "SME Growth Market" MTF venue, proposes an optional new harmonized prospectus regime for SMEs seeking admission to MTFs (Prospectus Regulation Proposal, Article 15). A lighter and proportionate regime is envisaged, as are novel prospectus format techniques, such as the use of a "Q & A" document rather than the traditional prospectus. But while a reform of this nature may ease costs for a limited number of smaller issuers,[147] it could lead to unintended effects. The introduction of a new harmonized prospectus regime, even on an optional basis, could mean that MTF venues become less able to compete and to

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[145] e.g. A. Pritchard, "Facebook, the JOBS Act and Abolishing IPOs" (2012) 35 Regulation 12, calling for different tiers of public and private market through which new issuers can progress.

[146] *Commission CMU Action Plan, p. 12*. The Parliament has similarly called for a reduction in the cost to SMEs of market access: *Draft Karas Report, para. 21*.

[147] The reform is projected to be available for 320 SME prospectuses and to yield annual savings in the region of €45 million: *Prospectus Regulation Proposal, p. 9*.

specialize, and that the ability of such venues to experiment with and develop distinct prospectus rule-books is reduced. Investor confusion may also follow as the harmonized MTF prospectus will be different to the harmonized regulated market prospectus. The proposed reform also shows some mis-understanding of the dynamics of MTF venues. While EU-mandated prospectus requirements do not apply to such venues, the admission process and the due diligence performed by the professional investors active in such venues acts as a proxy for investor protection and as a substitute for the harmonized prospectus. Certainly, the principle of trading venue neutrality implied in the reform has some appeal and the proposed disclosure regime for MTFs will apply only to SMEs and on an optional basis. Nonetheless, careful consideration will be needed of the costs associated with reducing MTFs' current discretion to compete on the basis of differentiated prospectus disclosure requirements, and with blurring the distinction between regulated markets and MTFs with respect to the admission of securities and disclosure.

Similar risks are generated by the proposal in the 2015 Prospectus Regulation Proposal to introduce a new and lighter prospectus for secondary (subsequent) issuances of securities where a company has already admitted securities to a regulated market or to an MTF where the MTF takes the form of an SME Growth Market (Prospectus Regulation Proposal, Article 14). This reform similarly blurs the line between the mandatory regulated market prospectus and the non-harmonized admission documents required by MTFs. It allows companies admitted to either venue to benefit from a lighter prospectus, although the mandatory, harmonized prospectus applies only to regulated market admission. The risks are all the greater as the EU's regulatory capacity to manage changes to the legislative regime which can have spill-over and unintended effects is weak.[148]

The risks of sub-optimal deregulation must also be managed. A degree of deregulation is to be expected after intense reform.[149] The CMU agenda may, however, have accelerator effects, particularly with respect to SME regulation. In relation to prospectus reform, for example, the CMU Action Plan characterizes the mandatory (regulated market) prospectus required of companies seeking finance as a "gateway to public markets," suggests that prospectuses are costly and onerous for SMEs to produce, and calls for a "genuinely proportionate" regime.[150] The 2015 Prospectus Regulation Proposal proposes a host of deregulatory reforms for the regulated market prospectus, including raising the thresholds of offer size below which a prospectus is not required. There is a reasonable logic to many of the reforms. But the prospectus is an investor protection device as well as a fund-raising mechanism and has long been so characterized by EU financial

[148] As has been evidenced by *European Parliament, Enhancing the Coherence of EU Financial Services Legislation (PE524.618v01-100) (2014).* There are particular difficulties at present with respect to the consistent meaning of definitions related to derivative instruments: Letter from Commission to ESMA, 26 February 2014. ESMA adopted clarifying Guidelines pending resolution of the issue under the MiFID II administrative rule-making process (ESMA/2015/675).

[149] As has been compellingly exposed by Jack Coffee's examination of the "regulatory sine curve": J. Coffee, "The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated" (2012) 97 Cornell Law Review 1019.

[150] *Commission CMU Action Plan, p. 12*.

regulation and policy; production of a prospectus requires a company to engage in detailed due diligence and verification of its disclosures, gatekeepers such as underwriters and analysts review the prospectus, and liability mechanisms act as a deterrent to fraud. Any reform must accordingly not lose sight of the investor protection function. It also remains to be seen how well-equipped the legislative and administrative process is to manage what will likely be an industry clamour for deregulation. At the legislative level, both the Commission and the European Parliament appear committed to not disturbing the crisis-era rule-book without cause.[151] The commitment under the CMU agenda to a "single rule-book" and to removing national options and derogations may also serve to reduce any undue industry pressure for deregulation. The ECB, which may come to play a significant role in shaping CMU if CMU and Financial Union become intertwined, has been robust in calling for consistent rule application and a single rule-book.[152]

The CMU agenda is also likely to require a series of technical revisions to and enhancements of EU regulation.[153] This is clear from, for example, the securitization reforms which seek to rationalize the current complex array of rules which applies to securitizations. To take another example, the need for deep market liquidity, particularly

[151] e.g. *Balz Resolution, paras. 3 and 4*, suggesting that the crisis-era reforms have strengthened Europe's financial architecture for future crises and recognizing the achievements of financial regulation in responding to the financial crisis.

[152] ECB, *Building a Capital Markets Union*. It has recently adopted a Regulation on the exercise of the options and derogations in the single rule-book which are available to the ECB as SSM supervisor, designed to minimize the impact of these mechanisms: ECB Regulation 2016/44 [2016] OJ L78/60.

[153] *CEPR, Restarting European Long-term Investment Finance, pp. 65-69.*

in the bond markets, is a recurring theme of the CMU agenda.[154] But the massive and novel MiFID II/MiFIR transparency regime for bond and derivatives markets, which will apply from 2018,[155] is likely to have far-reaching and unforeseen effects on market liquidity across a range of asset classes, given the costs the regime is likely to impose on market-making activities, and the risk of a related contraction in liquidity for these asset classes. While ESMA has engaged in intense modeling, empirical review, and market consultation in developing the related new administrative rules,[156] the effects of the new regime cannot be reliably quantified in advance. Calibration and correction may well be required.

*An Effective Legislative and Administrative Apparatus?*

It is not clear that the EU's legislative and administrative apparatus is optimally equipped to deal with these different technical challenges. The co-legislators have shown themselves to be equipped to manage complex regulatory design questions,[157] as is suggested by the speed with which ECOFIN Council came to agreement on the "simple,

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[154] *e.g. Bank of England, Response to the European Commission Green Paper, pp. 8-13*.

[155] The implementation date was originally 2017, but the complexities of the implementation process have led the Commission to propose a delay of a year.

[156] See e.g. the detailed analysis in its related proposals for Binding Technical Standards (ESMA/2015/1464)

[157] Of relevance to the CMU agenda in particular are the extensive revisions which the European Parliament's ECON committee proposed to the European Market Infrastructure Regulation (EMIR) in order to lighten the burden EMIR's risk management and hedging rules imposed on SMEs.

transparent, and standardized" securitization proposals,[158] and to engineer novel fixes to seemingly intractable political obstacles.[159] The co-legislators are also well supported by the ESAs, as is clear from the expertise the ESAs provided on how the EU might identify "simple, transparent, and standardized" securitizations and construct a related and calibrated regulatory regime.[160] Recent indications that the European Parliament may not object to the ESAs having an advisory role during level 1 negotiations[161] should further enhance the law-making process, including with respect to ESA understanding of any mandates for technical level 2 rule-making which may follow.

But difficulties remain. For example, the legislative process still struggles to make an optimal distinction between legislative level 1 rules and administrative level 2 rules for the EU financial system. The encrustation of deep and often politically-motivated detail in many level 1 rules,[162] and the removal thereby of the administrative process and its

[158] The ECOFIN Council reached political agreement in December 2015; the Commission proposals were presented in September 2015.

[159] Including with respect to the governance arrangements which apply to the new agencies of EU financial system governance, notably the Single Resolution Board. For a political science perspective, D. Howarth and L. Quaglia, "The Steep Road to European Banking Union: Constructing the Single Resolution Mechanism" (2014) 52 Journal of Common Market Studies 125.

[160] *EBA, Technical Advice on Qualifying Securitisations (2015*) and *Joint Committee of the ESAs, Joint Report on Securitisation (2015) (JC/2015/03*).

[161] *Balz Resolution, para. 48*.

[162] A classic case in point being the highly complex and technical exemption regime which applies to the transparency rules which apply to equity market trading and which was constructed by the Council and

capacity for developing technically-secure and empirically-based detailed rules, can lead to sub-optimal legislation. It can also obstruct the ability to the ESAs to develop effective level 2 rules. The considerable experience the co-legislators now have with the administrative rule-making process and with the supporting role played by the ESAs, gained over the intense crisis-era reform period, suggests that the level 1 process should more easily focus on principles and on the construction of clear mandates for level 2 rule-making. But there are countervailing factors. As the ESAs enhance their capacity and strengthen their institutional positions, the potential for institutional friction is likely to increase. For example, trust between the Parliament (careful to protect its prerogatives with respect to level 1 and also its constitutionally pre-eminent role as an over-seer (with the Council) of level 2) and the ESAs seems to be fragile. With respect to ESMA, the key ESA for CMU, there are some troubling signs of change to the generally strong ESMA/Parliament relationship which characterized ESMA's first five years.[163] While recent skirmishes[164] may be unrepresentative,[165] they may signal a growing lack of trust

Parliament: Markets in Financial Instruments Regulation 648/2012 [2012] OJ 173/84, art. 5 (the "volume cap mechanism").

[163] The European Parliament has from the outset been a supporter of ESMA acquiring additional powers: *European Parliament, Resolution on the European System of Financial Supervision, 11 March 2014 (P7_TA-PROV(2014)020).*

[164] In a recent fracas ECON Committee member MEP Ferber threatened to cut ESMA's funding following frustration (reported to be shared by ECON committee members) that ESMA was being obstructive over the MiFID II level 2 process: D. Ricketts and M. Marriage, "MEP Threat to Cut ESMA Funding" *Financial Times, Fund Management Supplement,* 6 July 2015, p. 2.

[165] In his recent Statement to the ECON Committee on Behalf of the ESAs (28 January 2016 ESMA/2016/102), ESMA Chairman Maijoor noted the "productive and cooperative relationship" between

between the Parliament and ESMA. Certainly, they do not augur well for the Parliament's willingness to delegate to level 2 over the CMU agenda and to adopt a more open-textured approach to level 1 legislation.[166]

Particular difficulties arise with respect to any CMU-required revisions to EU rules. Revisions to a level 1 legislative measure require the full co-legislation process and cannot easily be undertaken in a nimble manner. Revisions to administrative rules cannot be made by the technically-expert ESAs but must follow the relevant administrative rule-making procedures which locate rule-making power with the Commission. The pivotal ESA/Commission relationship appears to be working well after some five years of experience. But the ability of the Commission to veto or revise Binding Technical Standards proposed by the ESAs or their Technical Advice can lead to delays and, potentially, institutional friction. The inability of the cumbersome legislative and administrative processes to deal speedily with technical revisions has been repeatedly highlighted by different crisis-era reviews.[167] But the thicket of accountability and legitimacy difficulties and of constitutional conundrums (not least among them the need to ensure compliance with the *Meroni* prohibition on the exercise of widely-cast

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the ESAs and the ECON Committee and acknowledged recent ECON committee requests to improve ESA transparency.

[166] The Balz Resolution warns of the need to maintain a distinction between level 1 and level 2, emphasizes that political decisions are the prerogative of the co-legislators, warns that the ESAs and the Commission are to stay within their respect mandates, and regrets that the ESAs have not always "adhered to the mandates set by the European legislators": *Balz Resolution, para. 49*.

[167] e.g., *House of Lords, Do the pieces fit? pp. 43-45.*

discretionary powers by EU agencies[168]) surrounding any potential conferral of administrative rule-making power on the ESAs (or any construction of related remedial measures) means that solutions are not easy to design. Some signs augur well. ESMA and the Commission recently agreed on an "early review" process which is designed to ensure that legal mandate and other difficulties which may obstruct the adoption by the Commission of an administrative rule proposed by ESMA are flagged early on.[169] But however useful ad hoc solutions of this nature are, they do little to equip the EU with a stable and nimble means for correcting legislation and administrative rules. The EU also lacks an ability to suspend administrative rules quickly where necessary. The new MiFID II/MiFIR transparency rules, in particular, may require suspension if, as is possible, unforeseen and serious liquidity contractions, which disrupt the EU capital market, are generated. But an appropriately tailored procedure is not currently available under the administrative rule-making process.[170] The incentives of the Commission (as the location of administrative rule-making power) and the European Parliament (with the Council, responsible for oversight of administrative rule-making) for experimenting with solutions are limited, however.

Finally, it remains to be seen how the underlying political economy of EU financial governance will shape the CMU regulatory agenda. The financial crisis era has come to be associated with the dominance of "market-shaping" Member States, as opposed to the

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

[169] Letter to ESMA Chairman Maijoor to Director General Faull, 15 May 2015.

[170] ESMA has called for such a facility, subject to Council and European Parliament oversight: *ESMA Response to CMU*, p. 19.

"market-making" Member States.[171] Although coalitions shifted and preferences changed across different proposals, the dominant influence on the post-crisis legislative regime has been the persistence of a coalition of market-shaping Member States which was often market-sceptical, suspicious of unbridled Anglo-American capitalism, and geared towards regulatory intervention.[172] The CMU agenda, however, is an attractive one for Member States of a more liberal bent, in particular the UK. A greater degree of consensus can be expected as a result in ECOFIN Council negotiations, but clashes may arise where reforms have a deregulatory bent. The current difficult progress through the ECOFIN Council of the proposed Financial Transaction Tax under the Treaties' "enhanced cooperation" provisions,[173] and the challenge to its validity by the UK,[174] is a reminder of the deep-rooted institutional differences which continue to shape Member State interests. If CMU becomes entangled with EMU and characterized as a means for achieving a Financial Union, political differences may become acute (see also the next section below). The CMU agenda will also prove revealing as to the effectiveness of the post-crisis relationship between the Commission, which is spearheading CMU, and the

[171] e.g. L. Quaglia, "The 'Old' and 'New' Political Economy of Hedge Fund Regulation in the EU" (2011) 34 West European Politics 665.

[172] e.g. J. Buckley and D. Howarth, "Internal Market Gesture Politics? Explaining the EU's Response to the Financial Crisis" (2010) 48 (S1) Journal of Common Market Studies 119.

[173] In December 2015, ten Member States agreed on the common features of the proposed tax but Council discussions remain ongoing, given the need to ensure that the 'result is satisfactory to all Member States', including those not participating in the proposed new tax regime: ECOFIN Council, 3435th Council Meeting, 8 December 2015, Outcome of Council Meeting, p. 5.

[174] *United Kingdom v Council*. (Case C-209/13 ). On 30 April 2014 the Court rejected the challenge on the grounds that the action was premature as an FTT had yet to be adopted.

European Parliament, particularly as the Parliament has emerged from the financial crisis with a significantly enhanced reputation and as the victor of some notable trilogue battles with the Commission and Council.

In some respects the legislative and administrative processes are well-equipped to manage the CMU reform agenda. But the CMU project is likely to expose the persistent weaknesses in the EU's legislative and administrative processes, while the underlying political economy of EU financial system governance may limit the extent to which CMU can deliver the outcomes it seeks. In particular, it is not clear that the heavy political and institutional lifting which is needed if the serious structural obstacles to CMU which derive from, for example, differing taxation requirements, insolvency rules, and the limited portability of national pensions, can be achieved.

## CMU and EU Financial System Governance: Centralization or Fragmentation?

### *Regulatory Governance*

EU financial system governance has long been a laboratory for different styles of EU governance. In recent years it has been at the vanguard of the "agencification" of EU governance,[175] and of the related if tentative adoption of more experimentalist and fluid styles of EU governance, as noted below. But a persistent feature of EU financial system

[175] For a regulatory governance perspective see A. Ottow, "The New European Supervisory Architecture of the Financial *Markets" in M. Everson, C. Monda, and E. Vos (eds), EU Agencies In Between Institutions and Member States (Kluwer, 2014),* pp. 123-143 and *M. Everson, "A Technology of Expertise: EU Financial Services Agencies" (2012) LEQS WP No 49/2012*.

governance has been its heavy reliance on “command and control” regulatory governance in the form of legislation and administrative rules. EU financial system governance largely eschewed the move to “new governance” which characterized financial governance globally in the years prior to the financial crisis[176] – albeit this was less a function of a lack of support for a more fluid approach to governance and more a function of the legal architecture required to support a cross-border financial system. The financial crisis has seen the entrenchment of traditional regulatory governance, reflecting the dictates of the G20 reform agenda and the host of political, institutional, and market incentives for adopting a single rule-book.

The CMU project is unlikely to herald any radical changes to the current “command and control” style of regulatory governance currently dominant in the EU. CMU is a predominantly rules-based project - albeit one with some nuances, as noted ahead. It will also lead to a further intensification of regulatory governance, as is clear from the proposal to reshape the Prospectus Directive as a Regulation and thereby to remove Member State discretion. While there is a commitment to review the crisis-era rule-book[177] and to ensure it applies proportionately,[178] there is little evidence of an

[176] New governance in the financial markets field is typically associated with a “de-centred” regulatory environment in which a range of public and private disciplining tools are relied on and standard-setting is a responsive process involving dialogue between market actors and regulators: C. Ford, “New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation” (2010) Wisconsin Law Review 441.

[177] *Commission Call for Evidence 2015*.

institutional or political appetite to shrink the single rule-book to a material extent. But the scope of regulatory governance under CMU may come to have distinct qualities, depending on the nature of the interaction between the CMU project and euro area financial governance.

CMU-driven harmonization of regulatory governance is being associated with the reinforcement of the single market against the destabilizing effects - both centrifugal in the form of fragmentation effects and centripetal in the form of centralization effects - associated with Banking Union and the euro area. The successful action by the UK against the ECB's clearing policy (which the UK claimed discriminated against non-euro-area central clearing counterparties),[179] and the declarations in the 2014 MiFID II/MiFIR that Member States not be discriminated against on currency grounds,[180] are expressions of political and market anxieties in the UK as to the risks posed by euro area interests and related caucusing. So too is the July 2015 Joint Council and Commission Declaration, sought by the UK, that the European Financial Stability Mechanism cannot impose a liability on a non-euro-area Member State with respect to financial assistance to

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[178] The ECOFIN Council and European Parliament have recently called for the proportionate application of the single rule-book to be reviewed: *November 2015 Council Conclusions, para. 9* and *Balz Resolution, paras. C and* 58 (calling for proportionality checks).

[179] *ECB v UK*, 4 May 2015 (Case T-496/11), not yet reported. The Court did not address the discrimination but ruled against the ECB for lack of competence to adopt its policy.

[180] In a legally unnecessary but politically significant recital, MiFID II affirms that no action taken by ESMA or a national supervisor should directly or indirectly discriminate against any Member State as a venue for the provision of investment services and activities in any currency (recital 139).

a euro-area Member State.[181] Related remedial measures formed a central element of the UK's suite of renegotiation requests, agreement on which was reached through the February European Council New Settlement Decision,[182] as outlined earlier in this article. In this febrile environment, CMU, as a single market project, provides an expedient political balm, with its single-market orientation being heralded as supportive of the single market more generally.[183]

The principle of multi-speed financial system governance has, however, been established by Banking Union. The FTT negotiations taking place under "enhanced cooperation" further underline the potential for multi-speed financial governance. And, even allowing for a degree of institutional posturing, the statement by the ECB that, while "CMU is first and foremost an EU-28 agenda," enhanced cooperation in other ways could be explored, and its support for a "vanguard group" of countries to proceed on the basis of "enhanced cooperation," cannot be lightly dismissed.[184] The co-opting by the June 2015 Five Presidents' Report of CMU as a means for achieving Financial Union and for the completion of EMU further suggests that CMU may lead to further fragmentation between the single market and the euro area. Most significantly, the adoption through the New Settlement Decision of principles governing euro area/non euro area interaction

[181] Council Press Release No 593/15, 17 July 2015.

[182] *European Council Decision 18-19 February 2016*.

[183] e.g. *Commission CMU Green Paper* underlining that the objective is a "Capital Markets Union for all 28 Member States" (at p. 2). The ECOFIN Council has similarly stressed that CMU is a "project of shared importance for EU-28": *November 2015 Council Conclusions, para. 4*.

[184] *ECB, Building a Capital Markets Union, p. 5*.

with respect to financial system governance (including in relation to the differential application of the single rule-book to Banking Union banks), and of a political brake for related decision-making, as outlined above, has institutionalized multi-speed financial system governance within the EU.

Accordingly, while the CMU project is likely to intensify EU regulatory governance, this intensification may take place to different extents and within different spheres. A Financial Union, with intense and wide harmonization of capital market regulation and designed to reinforce Economic, Monetary, and Fiscal Union, may come to operate across the euro area. Outside this Financial Union a less intense form of harmonization may be deployed to facilitate the single-market-wide CMU. The Banking Union/single market relationship provides an operational template for such multi-speed integration. The Banking Union template is, however, characterized by the mutualization of supervisory risk and the related centralization of supervision, rescue, and resolution structures. Regulatory governance, thus far, has operated on a single-market-wide basis.

The sphere of application of CMU's regulatory governance is accordingly difficult to predict. But it can be predicted that CMU-driven regulatory harmonization will be significant. If its ambitions are fulfilled, the CMU project will lead to the encroachment of harmonization in areas where a degree of Member State discretion, given differences in local market structures and legal regimes, has long been tolerated - these may include company law, corporate governance requirements, and insolvency law, although the political and legal obstacles, and the related potential for a CMU and Financial Union disjunction, should not be underestimated. Member State discretion is also likely to be restricted in other less combustible areas. The Commission has, for example, canvassed whether a distinct harmonized financial reporting regime for EU SMEs be developed[185] – although the harmonized (IFRS-based) financial reporting regime currently applies only to the consolidated accounts of EU companies admitted to regulated markets (in practice, the largest companies); national reporting standards, attuned to local market, taxation, legal, and other features of domestic economies otherwise apply. This potential restriction of discretion is not unexpected, particularly in light of the crisis-era political and market support for the single rule-book. But the well-documented risks associated with the restriction of national discretion (relating to, for example, reduced ability to calibrate rules to local market structures, the loss of experimentation capacity, and the removal of incubators for local solutions which can shape EU intervention) arise.[186]

There are countervailing factors which may lead to a degree of sustainable regulatory divergence. With the CMU agenda the EU appears to be embracing, to some extent, a more experimentalist form of regulatory governance. Experimentalist governance has been identified as being based on the setting of general framework goals (by, for example, the EU's co-legislators, the Parliament and Council, through legislative rules) and on the related deployment - at lower levels of governance (such as industry

[185] *Commission CMU Action Paper, p. 13*. The Commission is to explore with the International Accounting Standards Board (which adopts IFRS) whether a voluntary, tailor-made solution can be developed for the EU.

[186] ESMA has supported local variation and discretion given the wide variation in the structures of capital markets across the EU: *ESMA, Response to the Prospectus Consultation (2015/ESMA/857), p.* 5.

groupings) and with a degree of flexibility and discretion - of different forms of implementing rules, of monitoring devices, and of mechanisms for revising goals and rules.[187] While the ESAs can be associated with experimentalist governance,[188] the Commission last deployed industry-led soft Codes and Guidance in any significant way in 2006, with its encouragement to the EU rating agency industry to follow the 2004 Code of Conduct adopted by the International Organization of Securities Commissions.[189]

But a return to a more experimentalist form of engagement may be underway. The CMU Green Paper acknowledges that "legislation may not always be the appropriate policy response" and that the Commission will support market solutions where they are likely to be effective.[190] Similarly, the ECOFIN Council has suggested that market-led initiatives and self regulation tools should be deployed where appropriate.[191] The CMU private placement initiative, for example, is linked to the work of a consortium of industry bodies

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[187] As identified by C. Sabel and J. Zeitlin: "Learning from Difference: the New Architecture of Experimentalist Governance in the EU" in *Sabel and Zeitlin, Experimentalist Governance, pp. 2-3*. See further *J. Zeitlin (ed), Extending Experimentalist Governance: The EU and Transnational Regulation* (Oxford University Press, 2015).

[188] For an experimentalist analysis of EU financial governance from the perspective of EBA *see E. Ferran, "The Existential Search of the European Banking Authority" ECGI Law Working Paper No 297/2015, available at http://ssrn.com/abstract=2634904*.

[189] *Commission, Communication on Credit Rating Agencies (2006)* ([2006] OJ L59/2).

[190] *Commission CMU Green Paper*.

[191] *November 2015 Council Conclusions, para. 6*. Similarly, the European Parliament has called on the Commission to take into account non-legislative and market-based approaches (*Balz Resolution, para. 6*).

who, following a mapping exercise by the Commission as to where the obstacles lie, have developed a market guide designed to support the development of a cross-border private placement market.[192] The Commission has similarly queried whether the standardization measures which could strengthen EU bond markets and deepen their liquidity should be achieved through regulatory intervention or market-led initiatives.[193] In another indication of a more flexible approach, the notion of opt-in harmonized regimes ("29th regimes"), bruited in the pre-crisis period but overtaken by the financial-crisis-era single rule-book reforms,[194] has been canvassed, including for a new portable personal pension product;[195] traces of this approach can also be seen in the 2015 Prospectus Regulation Proposal's proposal for an optional prospectus regime for MTF venues. Offering as it does the potential for a degree of experimentation and revision, the adoption of a "29th regime" approach would reveal much as to whether experimentalist forms of governance are beginning to shape EU financial governance. Similarly, the Commission has decided to follow a "wait and see" approach in areas where the appropriate regulatory response is not yet clear. With respect to crowdfunding, for example, it has opted to assess national regimes and best practice and to monitor the development of crowdfunding channels before taking action.[196]

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[192] *Commission CMU Action Plan, p. 11.*

[193] *Commission CMU Action Plan, p. 13.*

[194] Optional regimes were canvassed in the post-FSAP 2005 White Paper in which the Commission noted some scepticism, but remained "open": *Commission, White Paper on Financial Services Policy 2005-2010 COM (2005) 629, p. 13*.

[195] *Commission CMU Green Paper*, p. 17.

[196] *Commission CMU Action Plan*, p. 7.

*Supervisory Governance*

Perhaps the most intriguing question relates to supervisory governance and to the likely impact of the CMU project on institutional governance structures.[197] Will CMU follow the trajectory of Banking Union and lead to a greater centralization of capital markets supervision – even allowing for CMU and Banking Union being entirely different constructs?[198]

Capital markets supervision in the EU remains largely decentralized and is located with Member States' supervisors. Institutional support is provided by ESMA which carries out a range of supervisory coordination and convergence functions. ESMA also has a limited suite of direct supervisory powers. The minimal fiscal impact of particular financial market infrastructures and actors, combined with a supportive political and institutional climate over the financial crisis, led to ESMA being the sole ESA to be conferred with direct and exclusive supervisory powers over particular financial market participants (rating agencies and trade repositories for over-the-counter derivatives market data). Otherwise, and by contrast with Banking Union which is designed to mutualize risk and to support burden-sharing in order to ensure the stability of the euro-area banking system, fiscal neutrality remains the defining characteristic of EU-level supervisory governance

[197] For further discussion of this issue see Moloney, "Capital Markets Union" (2016) European Company and Financial Law Review, forthcoming.

[198] As has been repeatedly emphasized by the Commission and the EU institutions, including the ECB. The Commission has argued that CMU requires steps distinct from the key elements of Banking Union, but that Banking Union provides a "platform of stability" to underpin CMU: *Commission CMU Green Paper, p.* 5.

for the capital markets. Accordingly, supervision remains largely decentralized. Nonetheless, might the CMU agenda, in combination with the bedding in and normalization of the Banking Union structures, lead to spill-over effects which drive EU financial system governance towards the construction of a single capital markets supervisor – whether ESMA or another newly-minted institution?

Whatever the functional risks and benefits of such a development, there are a host of legal frictions which caution against predictions of CMU-related change to the organization of capital market supervision in the EU.[199] The constitutional obstacles alone are almost insurmountable. The *Meroni* doctrine, as recently interpreted by the CJEU with respect to EU financial system governance in the 2014 *Short Selling* ruling,[200] renders it legally very difficult for ESMA to be conferred with the wide range of discretionary supervisory powers which capital markets supervision would demand. ESMA's current suite of limited direct supervisory powers is confined by legislative and administrative conditions which would be difficult to apply in any operationally sensible manner to a full-scale EU markets supervisor. While Article 127(6) TFEU could support the transfer of some capital market supervision powers to the ECB, which operates free of administrative agency restrictions, these powers could only relate to prudential supervision and not to conduct supervision which is the mainstay of capital markets supervision. And the UK's declared opposition to any form of centralized capital market

[199] See further *N. Moloney, "Banking Union and the Implications for Financial Market Governance in the EU: Convergence or Divergence" in Busch and Ferrarini, Banking Union, pp. 524-563.*

[200] *UK v Council and Parliament* (Case C-270/12) 22 January 2014, nyr.

supervision[201] renders it politically highly unlikely that a new institution would be constructed under the Treaty's residual competence which requires a unanimous Council vote (Article 352 TFEU). Any such centralization would also require the mutualization of rescue and resolution risks and costs for a host of capital market actors to ensure that supervisory and rescue incentives were appropriately aligned. The immense constitutional difficulties which the construction of the Single Resolution Mechanism resolution fund provoked, including with respect to the Intergovernmental Agreement which governs the mutualization of national contributions within the resolution fund and which operates outside EU single market law, would pale in comparison with those which any attempt to construct a resolution fund for the potentially vast population of EU capital market actors would generate. The current slow progress towards a set of EU harmonized principles governing the resolution of systemically significant financial market infrastructures underlines the difficulties.[202] The ECB's recent controversial assertion that "the roadmap towards a genuine CMU….should thus include a single capital markets supervisor,"[203] might accordingly be best characterized as a means for the ECB to claim ownership over any discussions, however tentative, to centralize supervision, and of it seeking to influence any such institutional change, rather than as a

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[201] e.g. *Bank of England, Response to the Commission Green Paper.*

[202] There has been little progress since the Commission's pathfinder 2012 Consultation (*Consultation on a Possible Recovery and Resolution Framework for Financial Institutions other than Banks*), although informal consultations and impact assessment work is underway (*Commission, Roadmap, Framework for Resolution of non-bank Financial Institutions (2015)*), the Commission has committed to producing a proposal (*Commission CMU Green Paper*, p. 23).

[203] *ECB, Building a Capital Markets Union, p. 5.*

real statement of intent.[204] It may also indicate, however, that a euro-area Financial Union, with distinct supervisory and resolution structures to support capital market burden-sharing as well as distinct regulatory governance, is not to be confined to the realm of speculation.

Greater centralization of supervision in the form of stronger supervisory convergence may, nonetheless, follow. Unable to adopt administrative rules, ESMA operates in the shadow of Commission hierarchy[205] with respect to its quasi-regulatory activities. The potential for destabilizing and capacity-sapping tension with the Commission, while small, is real. Supervisory convergence and coordination activities, by contrast, allow ESMA to operate more freely and to strengthen thereby its hierarchical position over its constituent national supervisors (who form the membership of its decision-making Board of Supervisors). In addition, the establishment of the ECB within the Single Supervisory Mechanism as the prudential supervisor for euro-area banks has made available significant capacity-strengthening opportunities for ESMA.[206] ESMA is the natural institutional conduit through which national capital market supervisors can coordinate with the ECB, including on potential controversies relating to the often thin borderline

[204] A similar attempt to reinforce the institutions of Banking Union indirectly might be attributed to the equally controversial statement in the Five Presidents' Report on EMU that CMU might ultimately lead to a European capital markets supervisor: *Five Presidents' Report, p. 12*.

[205] On hierarchical institutional dynamics in EU governance see A. Héritier and D. Lehmkuhl, "Introduction: The Shadow of Hierarchy and New Modes of Governance" (2008) 88(1) Journal of Public Policy 1.

[206] See further *Moloney, "Banking Union".*

between prudential (ECB) and conduct (national supervisor) supervision. The arrival of Single Supervisory Mechanism has also generated significant incentives for ESMA not to lose ground to the ECB given the potential for spill-over effects from prudential bank supervision to shape its mandate and activities.

Recent indications point to a strengthening ESMA ambition and capacity with respect to capital markets supervision. They also suggest that an intensification of ESMA's supervisory activities will occur and will likely be accelerated by the CMU project. With respect to ECB relations, for example, while adopting a cooperative approach,[207] ESMA seems to have sought to establish an institutional pre-eminence with respect to EU-level coordination on capital market supervision. It has, for example, rejected a request by the ECB for the ECB to exercise two votes on the multi-supervisor CCP (central clearing counterparty) colleges of supervisors which ESMA oversees, despite some resistance from the ECB.[208] In addition, ESMA's peer review powers over CCP colleges,[209] which include oversight of likely controversial pan-EU stress tests and which ESMA is only beginning to test, are likely to further strengthen ESMA's supervisory capacity.[210] More generally, ESMA is adopting a more robust approach to peer review of its constituent

[207] An ECB/ESMA Memorandum of Understanding has been adopted: ESMA Press Release, 8 February 2016.

[208] The ECB called on ESMA to reconsider, but it declined to do so: ESMA Board of Supervisor Minutes, 7 May 2015 (ESMA/BS/90).

[209] ESMA Opinion on the Composition of CCP Colleges under EMIR (ESMA/2015/838)

[210] ESMA has prioritized its CCP college powers: *ESMA, Review of CCP Colleges under EMIR (2015) (ESMA/2015/20).*

national supervisors[211] and to its review powers more generally. In an important development, January 2016 saw ESMA, for the first time, issue a negative opinion under the Short Selling Regulation 2012,[212] in which it found emergency action by the Greek supervisor not to be appropriate or proportionate.[213] A significant ESMA decision-making capacity is, accordingly, becoming apparent, with the ESMA Board of Supervisors showing itself to have the capacity and the appetite to take robust action against its member supervisors where appropriate. ESMA's Strategic Orientation for 2016-2020, which is designed to set a new course for ESMA after its initial (2011-2015) build-up phase and to re-tool it as the pressure of its quasi-regulatory work recedes, also suggest a strengthening of ESMA's supervisory activities, including with respect to supervisory coordination and convergence, data collection, and market monitoring.[214] ESMA's first work programme on supervisory convergence, published in early 2016, affirms this trend.[215]

The CMU agenda offer further opportunities for ESMA to deploy its soft supervisory convergence and coordination powers more assertively, and to strengthen thereby its

[211] Its recent peer reviews of NCA supervisory practices with respect to best execution rules (ESMA/2015/494), and of compliance with the short selling regime for market making (ESMA/2015/1791), stands in sharp contrast to earlier more anodyne efforts, as they highlight specific failures, including by identified national supervisors.

[212] Regulation No 236/2012 [2012] OJ L86/1.

[213] *ESMA, Opinion, 11 January 2016 (ESMA/2016/28).*

[214] *ESMA, Strategic Orientation 2016-2020 (2015) (ESMA/2015/935)*, pp. 7-8.

[215] *ESMA, Supervisory Convergence. Work Programme (2016*).

institutional position within the ESFS with respect to capital markets supervision. ESMA has few incentives to claim additional direct supervisory powers, not least given the political sensitivities and the potential reputational risks attendant on its exercise of what must be constrained powers. But the CMU project's concern to reduce the regulatory and supervisory frictions obstructing cross-border capital-raising and to increase supervisory convergence[216] provides ESMA with an attractive opportunity to deploy its coordination powers in a capacity-strengthening manner. ESMA initial response to the CMU agenda bears out this prediction. ESMA has used the CMU agenda to signal the importance of, and to consolidate, its supervisory convergence role,[217] and to strengthen its currently shaky funding basis.[218] ESMA has also underlined its ongoing efforts to strengthen its risk monitoring ability, and argued that it is best placed to ensure that appropriate and consistent implementation and supervisory outcomes are achieved for CMU.[219] It has similarly highlighted the importance of its supervisory convergence activities to CMU,

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[216] *Commission CMU Green Paper, pp. 21-22.*

[217] Its Board of Supervisors has highlighted that supervisory measures within CMU can act as a substitute for regulation: ESMA Board of Supervisor Minutes, 19 March 2015 (ESMA/BS/59).

[218] ESMA's funding (like that of all the ESAs) is based on Member State and EU funding and was subject to a 15% funding cut in 2015, leading to a scaling back of ESMA's activities (ESMA, Letter to the Commission and Parliament, 18 February 2015 (ESMA/2015/168)). The Commission is, however, likely to accelerate (under the CMU agenda) its 2014 reform commitment to base ESA funding on market contributions. ESMA has used the CMU consultation to make the case for an "adequate staffing and funding system" (*ESMA CMU Response, p. 7*).

[219] *ESMA, Response to the Commission Green Paper*, pp. 4-5.

including with respect to market surveillance, peer review, and the identification and exchange of good practices, and has identified a related set of principles and priorities.[220] ESMA has proved somewhat less enthusiastic with respect to direct supervision, reflecting the sensitivities, although it has suggested that it is "uniquely positioned to develop a European supervisory approach that could have strong benefits for pan-European actors," and affirmed that "while clearly not asking for new areas of supervision", it "stands ready to assume such new tasks" should they be conferred.[221] Stronger supervisory convergence can accordingly be expected to follow given that ESMA has the necessary powers, incentives, and, increasingly, capacity to drive convergence and that CMU provides it with useful political and institutional cover.

**Conclusion**

Since 2008, the EU has been pre-occupied with a series of radical regulatory, supervisory, and institutional reforms to EU financial system governance, including the epochal Banking Union reforms. A period of reflection and stabilization might have been expected following the 2014 completion of the regulatory reform programme and the subsequent launch of Banking Union's Single Supervisory Mechanism and Single Resolution Mechanism. The CMU agenda, however, heralds a new period of instability for EU financial system governance.

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[220] Including with respect to ensuring that rules on cross-border and passporting activities are properly applied and to supporting more coordinated action by supervisors, including with respect to market monitoring and risk identification

[221] *ESMA, Response to the Commission Green Paper*, p. 5.

Drawing on a mosaic of perspectives, this article considers the implications of CMU for EU financial system governance. It suggests that, while its content remains somewhat thin, the CMU agenda may have important implications for the EU financial system and its governance; it may also prove revealing as to the impact of the February 2016 European Council Decision on a New Settlement for the UK within the EU. In order to consider more closely the implications of CMU, the article considers whether CMU is likely to achieve the transformative market outcomes it seeks, the risks of CMU and whether the EU has the regulatory capacity to adopt an optimal set of rules, and the wider effects on regulatory and supervisory governance for the EU financial system.

Whether or not, from a functional perspective, CMU can achieve the transformative effects it seeks in terms of the promotion of market finance is not clear given the experience with EU capital markets regulation to date. Accordingly, close attention must be given to the EU's ability to produce rules which have the strongest likelihood of supporting efficient market-based funding and of managing the risks associated with regulatory change under the CMU agenda. The article identifies a series of regulatory risks associated with the CMU agenda and considers whether the regulatory capacity of the EU is equal to managing these risks and to adopting the types of reforms necessary to achieve CMU. It concludes that the picture is mixed. While in many respects the legislative and administrative processes are now well-equipped to manage a reform agenda of this nature, the CMU agenda is also likely to expose the persistent and serious weaknesses in the legislative and administrative processes, particularly with respect to the EU's ability to finesse and calibrate rules.

The article also examines the wider effects of the CMU agenda on regulatory and supervisory governance for the EU financial system. With respect to regulatory governance, the single rule-book for the EU financial system is likely to widen and deepen and Member State discretion is likely to be further confined, although there are indications that a more experimentalist approach to governance may be deployed. But the complex interaction between the euro area interest in "completing EMU" and the single market interest in a facilitative CMU agenda makes it difficult to predict the scope of CMU-driven harmonization, particularly given the recent institutionalization of multi-speed integration under the February 2016 European Council Decision on the New Settlement for the UK. Similarly, the impact on supervisory governance remains unclear. It can be predicted reasonably safely that the CMU project is unlikely to lead to a centralization of supervisory governance for the single capital market through a central supervisor, although an enhancement of supervisory coordination through ESMA is likely to follow. It is less easy to reject the prediction that a euro-area Financial Union could become entangled with the CMU project, and include centralized supervisory, rescue, and resolution structures.