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Regulating financial markets under uncertainty: the EU approach

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Regulating Financial Markets under Uncertainty: The EU Approach

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Abstract:

This article assesses the European Union's post-crisis approach to regulating financial markets. Elasticity of financial markets forces rule-makers to make choices under uncertainty as to not only how financial markets will evolve, but also how regulated actors will respond to the measures adopted. Regulating highly complex and dynamic systems such as financial markets requires flexibility and adaptability which traditional regulatory techniques and instruments often lack. The European System of Financial Supervision, set up after the 2008 financial crisis, has taken a leap towards further harmonisation od rules and vertical consolidation of powers. To avoid the risks of stagnation and rigidness, a change in the overall mode of governance is needed. This article presents two short cases, one dealing with the modified disclosure regime of the revised Transparency Directive and the other with implementation of the Alternative Investment Funds Directive, in order to examine how uniformity can be pursued without the corresponding loss of flexibility. The case studies demonstrate how the techniques used by the European Securities Markets Authority (ESMA) and the Commission, which involve both formal and informal implementing measures, utilize the procedural flexibility of the post-Lisbon EU rule-making. But more flexible EU legislation is also needed because any system of delegation is redundant without enabling legislative acts that surrender meaningful normative authority to sufficiently independent regulators. The article also discusses the ambiguous limits of the system's flexibility in constitutional terms and addresses certain trade-offs and risks of the emerging mode of governance.

Keywords: European System of Financial Supervision, European Supervisory Authorities, ESMA, financial crisis, harmonisation, single rulebook, governance, Lisbon Treaty, AIFMD, Transparency Directive

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Introduction

The evolution of European Union financial regulation is often described as having different phases, each with its own characteristics, agendas and specific circumstances.[1] The origins of the present phase lie in the 2007–2008 financial crisis and is characterised, first and foremost by an increasing focus on supervision and enforcement of rules (beyond rules in books) as well as emphasis on the importance of safeguarding financial stability.[2] These goals have been backed by "far-reaching and radical" institutional reforms which have resulted in a novel supervisory architecture known as the European System of Financial Supervision (ESFS).[3] The on-going reforms also have a markedly international dimension: a number of legislative initiatives are based on "G20 commitments" and preliminary work undertaken by the Financial Stability Board acting under its auspices.

The more centralised regulatory and supervisory structure works in tandem with the effort to further integrate EU financial markets and eradicate unwanted divergence in the financial laws and regulations of the Member States. As a token of the prevailing maximum harmonization policy, EU institutions and legislative acts now frequently underline the Union policy to develop a "single rulebook" for the European financial industry. The newly

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[1] See e.g. N. Moloney, *EC Securities Regulation*, 2nd edn (Oxford: Oxford University Press, 2008), pp. 11–16.

[2] T. Tridimas, "EU Financial Regulation: Federalization, Crisis Management, and Law Reform", in E. Wymeersch, K. Hopt, G. Ferrarini (Eds.) *Financial Regulation and Supervision: A Post-Crisis Analysis* (Oxford: Oxford University Press, 2012), p. 785. On the pursuit of financial stability as a (partly ill-judged) driver of EU legal integration, see M. Andenas and I. H.-Y. Chiu, "Financial Stability and Legal Integration in Financial Regulation" (2013) 38 E.L. Rev. 335.

[3] European Commission, Regulating financial services for sustainable growth: A progress report – February 2011 *http://ec.europa.eu/internal_market/finances/docs/110209_progress_report_financial_issues_en.pdf* [Accessed March 15, 2014]

found, sector-specific European Supervisory Authorities (ESAs) are vested with considerable authority to implement the rulebook and give guidance with regard to its correct application.

Diminishing competence and discretion of Member States' competent authorities is highly problematic both legally and in terms of governance. But the question that this article focuses on is whether the ESFS as a regulatory system is sufficiently flexible in procedural or structural terms. The importance of this question is underlined by the fact that the broadening perimeter of post-crisis EU financial law makes law reform increasingly dependent on centralised EU activity. Accordingly, Professor Tridimas observes that maximum harmonisation exposes EU financial regulation to the danger of stagnation and risks compromising the regulator's ability to respond to fast-evolving circumstances. The way to deal with this problem, he concludes, would be to preserve enough substantive flexibility in legislative acts and to provide an efficient system of delegated legislation.[4]

More flexible EU legislation and a better functioning system of delegation were targeted already by the so-called Lamfalussy approach. The Lamfalussy Report[5], delivered in 2001, identified a lack of flexibility as the principal shortcoming of the EU financial regulation and consequent reforms aimed to set up a regulatory structure that would be more flexible and less dependent on level 1 legislative input. The call for enhanced flexibility reflected a need for faster law-making but, perhaps above all, more adaptable rules. It is a truism that financial regulators hardly ever get the regulations right once and for all – once the elastic capital markets adjust or innovate, rules often need to be adjusted as well. The result is often

[4] Tridimas, "EU Financial Regulation: Federalization, Crisis Management, and Law Reform" in Wymeersch, Hopt, Ferrarini (Eds.) *Financial Regulation and Supervision: A Post-Crisis Analysis* (2012), p. 793.

[5] *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets*, Brussels, 15 February 2001.

a dialectic process between financial and regulatory innovation.[6] But regulators innovate, too. Regulatory innovation can involve e.g. rule-making procedures and different regulatory instruments. Thus while financial innovation notoriously creates activities and instruments that go beyond the regulatory perimeter, regulatory innovation similarly employs new regulatory instruments and procedures that can, inter alia, provide more sensitivity to changes in regulated markets but which also straddle the constitutional boundaries of rule-making.

Indeed, the last decade of EU financial regulation has been particularly active in terms of regulatory innovation.[7] But in the wake of the financial crisis the EU determined (after some hesitation) that the Lamfalussy system had serious shortcomings: it had fallen short of attaining the dual target of (a) more uniform financial regulation and consistent application of rules at the Member State level and (b) less detailed and prescriptive financial legislation at the Union level.

This article examines how the regulatory structure laid down by the ESFS, leveraged by the TFEU framework of delegated "non-legislative" rule-making, pursues uniformity with a combination of increasingly formal, delegated rule-making and soft, administrative rule-making that still remains informal and un(der)proceduralised. Two case-studies illustrate the role of the European Securities Markets Authority (ESMA) in both of these rule-making techniques: a modified shareholders' disclosure regime under the revised Transparency

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[6] On this kind of elasticity of markets, see F. Partnoy, "Financial Derivatives and the Cost of Regulatory Arbitrage" (1996-1997) 22 *The Journal of Corporate Law* 211, pp. 249–252. The term "regulatory dialectic" was apparently introduced by E.J. Kane. See e.g. Kane, "Interaction of Financial and Regulatory Innovation" (1988) 78 *The American Economic Review*, 328.

[7] N. Moloney, "Innovation and Risk in EC Financial Market Regulation: New Instruments of Financial Market Intervention and the Committee of European Securities Regulators" (2007) 32 E.L. Rev. 627, pp. 631–635.

Directive[8] shows how more functional legislative provisions can promote flexibility, whereas the ESMA Guidelines on Key Concepts[9] of the directive on Alternative Investment Fund Managers (AIFMD)[10] demonstrate how a more informal "perimeter control" can promote consistent application of the rulebook. The article seeks to highlight the importance of more flexible and adaptable EU legislation. Any system of delegation is redundant without enabling legislative acts that surrender meaningful normative authority to sufficiently independent regulators.

The article focuses on securities markets regulation. This choice is not made in neglect of the major reforms pending in the area of Eurozone banking supervision. Indeed, the EU is about to proceed with yet another financial supervisory reform. The Single Supervisory Mechanism (SSM) will put in place a highly centralized banking supervision led by the European Central Bank (ECB) and it presents a decisive step towards a genuine banking union.[11] Although the impacts of pending Eurozone reforms are potentially dramatic, also with respect to banking supervisory structures already in place, this article does not analyse or anticipate them. However, the findings about the importance of regulatory flexibility are equally important in the context of evolving banking supervision.

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[8] Directive 2013/50/EU amending Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market [2013] OJ L294/13.

[9] Final Guidelines on Key Concepts of the AIFMD, ESMA/2013/611 (13 August 2013).

[10] Directive 2011/61/EU on Alternative Investment Fund Managers [2011] OJ L174/1.

[11] Council Regulation 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] L287/63 and Regulation 022/2013 of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) [2013] OJ L287/5.

The article also assesses the somewhat ambiguous constitutional boundaries constraining the dynamics of EU regulatory innovation because they condition the system's flexibility and play an important part in determining the fate of Europe's system of financial supervision. Finally, certain trade-offs and risks of the emerging mode of governance will be addressed.

Why regulating financial markets is so difficult

Before delving into the structure of post-crisis EU financial regulation, it will be briefly discussed why regulation of financial markets seems to be such a difficult art. After all, every regulatory measure is adopted under uncertainty of how regulated entities and individuals will react to new rules (unintended consequences, arbitrage) and how exogenous changes such as technological innovation will shape the regulated environment. But financial markets provide an example of a border-crossing environment that is particularly complex and unpredictable, and thus subject regulatory measures to the constant risk of becoming obsolete or at least incomplete. The global financial crisis also highlighted the fact that complacent law-makers and regulators can overlook risky trends and have few working tools for other than micro-prudential oversight. The years leading to the crisis of 2008 witnessed a combination of a relatively lax regulatory environment, low interest rates and abundant capital with a high yield appetite to fuel the explosive growth of securitized credit and different synthetic instruments.[12] In the meantime, the global system of financial

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[12] Financial Services Authority, "Turner Review: A regulatory response to the global banking crisis" (2009) *http://www.fsa.gov.uk/pubs/other/turner_review.pdf* [Accessed March 15, 2013] and Z. Pozsar, T. Adrian, A. Ashcraft, and H. Boesky, "Shadow Banking", Federal Reserve Bank of New York Staff Reports, no. 458, July 2010 (revised February 2012) *http://www.ny.frb.org/research/staff_reports/sr458.pdf* [Accessed March 15, 2013]; and "The origins of the financial crisis: Crash Course" *The Economist*, September 7, 2013 (Schools brief).

intermediation reached a level of complexity so incomprehensible that applied physics might not be a bad source of inspiration when regulation is being redesigned around the globe.[13]

However, complexity of financial regulation is also increasing and the regulatory perimeter expanding. Especially after the crisis, many areas of the financial industry that used to be relatively regulation-free, such as OTC derivatives and hedge funds, are now the primary focus of legislators. From the regulator's corner increasingly complex regulation might just respond to the complexity of financial structures, but this causality also works the other way around: complex regulation is known to promote complexity in financial structures and functions.[14]

"Futurization" provides a good example of how little of this underlying dialectics has changed after the crisis: while the 2010 Dodd-Frank Act[15] in the United States introduced many new rules targeted at previously largely unregulated swaps markets, many issuers seem to respond by migrating their swaps into futures markets that will face a less onerous regulatory burden.[16] Futurization is a textbook example of unintended consequences of

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[13] S. Schwarcz, "Regulating Complexity in Financial Markets" (2009) 87 *Washington University Law Review* 211, p. 236, noting that the causes of financial market failures are in many ways similar to the non-linear feedback effects found by engineers working with complex systems. See also S. Battiston, G. Caldarelli, Co-P. Georg, R. May and Stiglitz, "Complex Derivatives" (2013) 9 *Nature Physics* 123.

[14] Spatt, "Complexity of Regulation" (2012) 3 *Harvard Business Law Review Online, http://www.hblr.org/ 2012/06/complexity-of-regulation/* [Accessed March 15, 2013].

[15] The Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, H.R. 4173.

[16] CME Group Inc. launched a so-called interest-rate swap futures contract, which is basically a futures contract that is converted to swaps if held until delivery. "CME Derivatives That Skirt Dodd-Frank Attracting Review by CFTC", *Bloomberg Businessweek, http://www.businessweek.com/news/2013-02-19/cme-derivatives-skirting-dodd-frank-rules-attract-cftc-review*. [Accessed March 15, 2013] Bart Chilton, the Commissioner of the U.S. Commodity Futures Trading (UTFC), has also expressed his concern at the issue of

financial regulation and also provides a good example of how financial instruments can be tailored for regulatory regimes. But it is not all about checks and balances: not every financial innovation is a response to regulatory measures and innovation can be driven by genuine demand for, by way of examples, risk diversification, smaller transaction costs or better access to finance.[17] In a similar vein, regulation must not only curb and restrain but also must facilitate and smooth financial intermediation by upholding the market infrastructure, particularly its legal fundamentals. On the other hand, the maxim that financial innovation is the "engine driving the financial system toward its goal of greater economic efficiency"[18] seems much less axiomatic in the post-crisis world. For instance, it now seems evident that the shift of risks from the balance sheets of the loan originators to global capital markets through complex chains of esoteric securitization techniques does not automatically lead to optimal allocation of those risks. Neither does packaging and slicing of risk necessarily make it more visible. On this global market for "onions", where "one peels

converting certain swaps into futures "in an attempt to export the deregulated, opaque swaps trading model to these new futures markets". *http://www.cftc.gov/PressRoom/SpeechesTestimony/ chiltonstatement013113* [Accessed March 15, 2013]

[17] On the benefits of financial innovation, see R. G. Rajan, "Has the Financial Development Made the World Riskier?" NBER Working Paper No. 11728, October 2005 (where also the risks of development were famously anticipated) See also Schwarcz, "Regulating Complexity in Financial Markets" (2009) 87 *Washington University Law Review* 211, at p. 213-214, 239. In classifying financial innovations during the 1980s, Finnerty found in total 11 different factors. See Finnerty, "Financial Engineering in Corporate Finance: An Overview" 4 *Financial Management* (1988), 14–33.

[18] R. Merton, "A Functional Perspective of Financial Intermediation" (1995) 24 *Financial Management* 23, pp. 36–37.

successive layers of debt and wonders whether there is any solid core at all",[19] not even the seller is necessarily aware of the product's defects.

By now it is well understood that non-transparent leverage of many complex financial instruments can accumulate hidden debt and risk particularly in a low interest-rate environment. Various regulations have been crafted in response to the perceived market failures. Regulation of risk-taking and transparency partly works as a substitute for a more responsible monetary policy, which remains hostage to stagnant economic growth and unemployment.[20] But the regulatory debate goes beyond individual measures: while most agree that regulation is needed, questions of governance continue to spur diverse discussions: *what kind* or regulation is needed and *how* it should be made and enforced? Traditional command and control techniques of regulation have been stated as ill-suited for complex and dynamic environments such as financial markets well before the crisis. Instead, techniques with more modern features such as flexibility, diversity, experimentalism, and continuing deliberation have been promoted. These "new modes of governance" have varying characteristics but they commonly prefer networks or similar horizontal governance infrastructures to hierarchy with a view to encouraging stakeholder participation – the idea being that the relationship between the regulator and the industry should be cooperative, not adversarial.[21] Some of the strategies are dubious of the benefits of hard law instruments in

[19] This apt metaphor is from Richard A. Posner, *The Failure of Capitalism: The crisis of '08 and the descent into depression* (Harvard University Press, 2009), p. 14.

[20] On rethinking monetary policy, see Raghurajam G. Rajan in *Fault Lines. How Hidden Fractures Still Threaten the World Economy*. (Princeton University Press, 2010), pp. 168–169.

[21] See generally J. Black, "Paradoxes and Failures: 'New Governance' Techniques and the Financial Crisis" (2012) 75 *Modern Law Review* 1037; G. de Búrca and J. Scott, "Introduction: New Governance, Law and Constitutionalism" in G. de Búrca and J. Scott (eds) *Law and New Governance in the EU and The US* (Oregon:

general, which they consider better suited for relatively stable conditions, and instead promote softer measures (i.e. formally non-binding acts) which can be renegotiated and reformed in the course of evolving circumstances.[22] Soft law bodies are also preferred because their decision-making structures are more flexible and thus better able to increase the agility and adaptability of rule-making.[23] Although some supervisory regimes with a positive attitude towards New Governance ideas failed to anticipate and tackle the crisis, for its proponents these failures do not discredit the approach or necessitate a return to command and control regulation.[24]

Against this backdrop, the remainder of this article will analyse the post-crisis EU financial supervisory structure and the perceived ability of the prevailing "EU approach" to better respond to the challenges of financial markets regulation.

Updrading the Lamfalussy system

What the Lamfalussy system did not achieve

The interplay between financial innovation and regulation has been characteristic of EU financial regulation as well. Regulatory initiatives have been mostly reactive: for instance,

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Hart Publishing, 2006) p. 3; and C. Ford, "New Governance, Compliance, and Principles-Based Securities Regulation" (2008) 45 *American Business Law Journal* 1.

[22] D.M.Trubek, P. Cotterell, and M. Nance, "'Soft Law', 'Hard Law' and EU Integration" in de Búrca and Scott (eds) *Law and New Governance in the EU and The US* (2006), p. 88 (analysing the EU's Growth and Stability Pact).

[23] E. Ferran and A. Kern, "Can Soft Law Bodies be Effective? The Special Case of the European Systemic Risk Board" (2010) 35 E.L. Rev. 751, p. 756.

[24] Black, "Paradoxes and Failures: 'New Governance' Techniques and the Financial Crisis" (2012) 75 *Modern Law Review* 1037 and C. Ford, "Principles-based Securities Regulation in the Wake of the Financial Crisis" (2010) 55 *McGill Law Journal*, 257.

most initiatives introduced in 1999 under the ambitious Financial Services Action Plan (FSAP)[25] were designed to respond to unforeseen developments in technology or market environment.[26] But implementation of the FSAP relied on a legislative framework that was, according to the Lamfalussy report, “too slow, too rigid, complex and ill-adapted to the pace of global financial market change”.[27] The objective of the Lamfalussy report’s initiatives was therefore to enable faster and better promulgation and implementation of financial rules by combining a “more modern, streamlined and flexible decision-making structure” with more flexible legislation that could be “adapted more quickly in response to innovation and technological change in financial markets.”[28] There exist several good overviews of the four-level Lamfalussy regulatory structure and they need not be replicated here.[29] But the structure’s overall purpose was to provide flexibility by preserving “level 1” legislative acts for high-level principles and policies, whereas more detailed implementation of rules should have been left for lower levels of regulation.

The achievements of the Lamfalussy system were somewhat mixed. It did help to deliver the FSAP agenda (totaling 42 measures) on time, and improved the quality of legislation through improved consultation processes.[30] Technical quality was improved with

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[25] European Commission, Implementing the framework for financial markets: Action Plan COM(1999) 232.

[26] Moloney, *EC Securities Regulation* (2008) pp. 16–17.

[27] *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets* (2001), p. 7.

[28] European Commission, The Application of the Lamfalussy Process to EU Securities Markets Legislation: A preliminary assessment by the Commission services SEC(2004) 1459, p. 3, 12.

[29] Se eg E. Ferran, *Building an EU Securities Market* (Cambridge University Press, 2005), pp. 58–126.

[30] Inter-Institutional Monitoring Group, *Final Report Monitoring the Lamfalussy Process*, 15 October 2007, p. 8.

involvement of the three advisory committees (Level 3 Committees) in the regulatory process as the committees had the necessary expertise and necessary links to stakeholders.[31]

But the Lamfalussy approach did not achieve either of its central objectives. First of all, it fell short of attaining more uniform and integrated EU securities markets.[32] The directives provided the primary building block of the FSAP securities regulation.[33] Therefore, implementation relied heavily on national measures which were often not only delayed but also divergent.[34] In terms of implementation, horizontality still prevailed.[35] There were also more informal means of promoting convergence, particularly the extensive soft law guidance of the Committee of European Securities Regulators (CESR),[36] but the Member States' acceptance and adoption of non-binding measures remained limited while creative transposition measures resulted in divergent outcomes.[37] In short, it became clear that the

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[31] The Lamfalussy Committees consisted of representatives of the respective national supervisory bodies and they exercised an important advisory function in developing the legislative and implementing measures.

[32] L. Enriques, M. Gatti, "Is there a Uniform EU Securities Law After the Financial Services Action Plan?" (2008) 14 *Stanford Journal of Law, Business & Finance* 43.

[33] See the list of adopted measures in European Commission, Review of the Lamfalussy process COM(2007) 727 final, [2008] OJ C 55, Annex II.

[34] European Commission, Review of the Lamfalussy process (2007).

[35] See also R. L. Lastra, "The Governance Structure for Financial Regulation and Supervision in Europe" (2003) 10 C.J.E.L. 49, p. 59.

[36] See N. Moloney, "The Committee of European Securities Regulators and level 3 of the Lamfalussy Process" in M. Tison, H. De Wulf, C. Van der Elst, R. Steennot (eds), *Perspectives in Company Law and Financial Regulation: Essays in Honour of Eddy Wymeersch* (Cambridge University Press, 2009).

[37] The Commission was surprisingly optimistic in trusting that non-binding guidance should have prevented national regulators from adopting additional measures. European Commission, Review of the Lamfalussy process (2007), para. 4.3.2. The CESR's peer reviews also confirmed divergent outcomes and non-compliance. See Ferran, "Understanding the New Institutional Architecture of EU Financial Market Supervision" in

Committees that were designed to drive convergence and consistency in the application and implementation of EU financial legislation were failing to deliver.

Secondly, the FSAP legislation often resulted in excessively detailed provisions, which were less principles-based and outcomes-oriented than envisaged by the Lamfalussy principles.[38] The likely obstacles were both political and structural: a highly fragmented institutional structure and the dynamics of EU federalism promote high level of legislative detail – also in securities regulation.[39] Even where something resembling principles-based legislation was produced (e.g. Market in Financial Instruments Directive, MiFID[40]) the EU supervisory system was unable to impose sufficiently uniform implementation and application of the rules.

Thus the FSAP rulebook came to be both detailed and divergent, which aggravated uncertainty and hindered development of the single financial market. More integrated rulemaking was called for in order to create a true level-playing field. The financial crisis acted as a final catalyst for stronger EU intervention.

The European System of Financial Supervision (ESFS)

The spur for structural change after the crisis was given by yet another high-level expert report. The group chaired by Jacques de Larosière envisaged a profound review of EU supervisory system as well as adoption of a fully harmonized core set of rules that would be

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Wymeersch, Hopt, and Ferrarini (eds) *Financial Regulation and Supervision: A Post-Crisis Analysis* (2012) pp. 122–123.

[38] Inter-Institutional Monitoring Group, *Final Report Monitoring the Lamfalussy Process* (2007).

[39] R. D. Kelemen, *Eurolegalism*, (Cambridge: Harvard University Press, 2011), pp. 97– 116.

[40] Directive 2004/39/EC on markets in financial instruments, [2004] OJ L145/1.

based on directly applicable regulations.[41] The Lamfalussy system had reportedly produced incoherence either by too much optionality in legislation or by failing to equip level 3 Committees with necessary powers.[42] The rationale for prescribed harmonisation echoed the concern over the effectiveness of the single financial market, but diversity had also compounded the problems of crisis prevention and management.[43] De Larosière report advised that even where directives were needed, maximum harmonization of core issues should be achieved.[44]

These propositions matched the reformist mood of the EU institutions, particularly that of the European Parliament.[45] The Commission followed suit by quickly sketching an outline of the renewed supervisory architecture.[46] Finally, the European Council recommended enhancement of both micro and macro-prudential supervisory functions with the establishment of new EU level bodies.[47] Three financial supervisory agencies, the ESMA, the EBA and the EIOPA, started their work already in January 2011 when they also assumed

[41] *Report by the High-Level Group on Financial Supervision in the EU chaired by Jacques de Larosière*, 25 February 2009 (De Larosière report).

[42] De Larosière report, p. 27

[43] De Larosière report, p. 27

[44] De Larosière report, p. 29.

[45] The Parliament has been the most enthusiastic proponent of a more integrated supervisory framework. See e.g. European Parliament resolution of 9 October 2008 with recommendations to the Commission on Lamfalussy follow-up: future structure of supervision, (2008/2148(INI)).

[46] European Commission, Driving European recovery COM(2009) 114 final; European Commission, European financial supervision COM(2009) 252 final.

[47] European Council, Presidency Conclusions of the Brussels European Council (18/19 June 2009), paras 19–20.

the tasks of their predecessor committees.[48] The ESAs, together with the European Systemic Risk Board (ESRB)[49] and national competent authorities form the institutional foundations of the ESFS (see the table).

[48] Respective establishing Regulations are (EU) No. 1093/2010 (EBA), (EU) 1094/2010 (EIOPA), (EU) 1095/2010 (ESMA) [2010] OJ L331.

[49] Established by Regulation 1092/201 [2010] OJ L331.

The European System of Financial Supervision (ESFS)

EU Level

	Body	**Predecessor Lamfalussy Committees (until January 2011)**	**Main tasks/responsibilities**
Macro-stability	European Systemic Risk Board (ESRB)	-	Supported and hosted by the European Central Bank, the ESRB conducts macro-prudential oversight of EU financial markets. It is designed to prevent or mitigate systemic risks to EU's financial stability.
Micro-prudential supervision	European Securities Markets Authority (ESMA) European Banking Authority (EBA) European Insurance and Occupational Pensions Authority (EIOPA) (together, the ESAs)	Committee of European Securities Regulators (CESR) Committee of European Banking Supervisors (CEBS) Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)	In their respective fields, the ESAs participate, inter alia in: – creation of the "European Single Rulebook" – prevention of regulatory arbitrage – protection of customers – maintenance and promotion of stability, integrity and transparency of financial markets – international supervisory coordination – direct supervision (e.g. ESMA supervises Credit Rating Agencies) – enforcement (as a rule subject to Commission oversight)
	Joint Committee of the ESAs	(3L3 committees)	Cooperation to ensure cross-sectoral consistency between the ESAs.

Member State level

The competent supervisory authorities of the Member States

The ESAs were designed to transform the network-based Level 3 committees into "supervisory authorities with real teeth".[50] The fulfilment of the ESAs' objectives was considered to require legal personality as well as administrative and financial autonomy.[51] Unlike their predecessors, the ESAs are independent legal entities with robust organization and institutionalised powers. Their regulatory independence is significantly greater: a preamble to their establishing regulations even states that the ESA's acts should form an integral part of Union law.[52] Notwithstanding, the EU Treaties do not recognize ESAs as union institutions and as such their role corresponds with other European agencies established by secondary Union law.[53]

In terms of regulation, the ESAs' overarching task is twofold: they contribute to (a) establishment of high-quality common regulatory and supervisory standards and practices and (b) consistent application of legally binding Union acts.[54] To achieve these objectives, they can issue non-binding opinions, guidelines, and recommendations but also develop binding technical standards. Finally, under the ESFS enforcement regime, the ESAs are capable of taking direct decisions in the event that (a) EU law that defines clear and unconditional obligations is breached (art. 17)[55]; (b) an "emergency situation" occurs (art.

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[50] *http://ec.europa.eu/internal_market/finances/index_en.htm* [Accessed March 15, 2013]

[51] Regulation 1095/2010 (the ESMA Regulation), rec. 14 (The ESAs' founding regulations are almost identical. For the sake of simplicity, when all ESAs are addressed, references shall be made to the ESMA Regulation only).

[52] The ESMA Regulation, rec. 51.

[53] For the definition of European agencies, see S. Griller and A. Orator, "Everything Under Control? The 'way forward' for the European agencies in the footsteps of the Meroni Doctrine" (2010) 35 E.L. Rev. 3, p. 6–9.

[54] The ESMA Regulation, arts 8(1)(a) and (b).

[55] The ESMA's power is a last resort and any decision pursuant to the article must be preceded by and be in conformity with a formal opinion issued by the Commission. (art. 17(6)(2)).

18)[56]; or (c) national supervisors are in persistent disagreement with each other (art. 19). These direct powers cast a shadow of hierarchy over the national regulators and can facilitate compliance, even if the exercise of the powers is in many ways constrained and controlled. Direct intervention powers as a rule are not supposed to result in legal instruments of general effect and application, but a recently decided case demonstrated well how drawing the border between executive acts of non-general application and generally applicable regulatory acts can be difficult.[57]

Can maximum harmonization be flexible?

The ESFS was set to tackle first and foremost the first shortcoming of the Lamfalussy process, i.e. the lack of uniformity and inconsistent supervisory practices. In the build-up phase of the new supervisory architecture, the Commission explicitly stated the need to identify and remove "exceptions, derogations, additions, or ambiguities" from the financial services directives and expressed its desire to replace them with a level-playing field based on one harmonized core set of standards.[58] Member States should continue to be able to require additional information or impose more stringent requirements ("gold plating") but only *when legislative acts so provide*.[59] Thus while the "single rulebook" is admittedly an

[56] The existence of an emergency situation must be determined by the Council (art. 18(2)).

[57] Certain direct powers of the ESMA under the Short Selling Regulation were challenged by the UK, but in its recent judgement the Court held that such executive measures, even if generally applicable, were in the confines of EU law. *United Kingdom v Parliament and Council* (C-270/12) January 22, 2014.

[58] European Commission, European financial supervision (2009), pp. 3–4.

[59] As stated in the Directive 2010/78/EU L 331/120 (Omnibus I Directive), rec. 14.

EU slogan with little palpable substance[60], it does carry the hallmark of the EU policy to regulate financial markets to the extent possible with a single set of mandatory rules.

Success of the ESFS is nevertheless closely related to resolving the second shortcoming of the Lamfalussy approach, i.e. the avoidance of unnecessary detail and prescriptiveness in level 1 legislative acts. But are not these two goals, flexibility and consistency, mutually exclusive? Indeed, in substantive terms, uniformity and flexibility locate at the opposing ends of a single continuum.[61] Within this one-dimensional continuum uniformity would be achievable by way of detailed and specific legislative packages with as little optionality and ambiguity as possible. Such an approach would be an effective way to impose a single rulebook, but it would suffer from similar problems than did the "too slow, too rigid, complex, and ill-adapted" EU regulatory framework that the Lamfalussy initiatives were specifically designed to eliminate. Experiences from the Lamfalussy era indicate that if the EU wishes to increase flexibility of legislative acts without giving way to inconsistent and less integrated financial market, it needs to assume greater authority over implementation, interpretation, and enforcement of EU financial law. The ESFS provides a supervisory structure that appears better equipped to do exactly that.

But structural and institutional reforms only provide the necessary means. Any system of delegation is redundant without enabling legislative acts that surrender meaningful normative authority to independent regulators. Indeed, flexibility of the ESFS rests on

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[60] E. Wymeersch, "Europe's New Financial Regulatory Bodies" (2011) 11 *Journal of Corporate Law Studies* 443, p. 449. Wymeersch is admittedly right in criticizing the concept of its substantive ambivalence, noting that "[r]ather than a rulebook, it would be a collection of discrete instruments, each having its own dynamics, definitions, structure and sanctioning."

[61] G. De Búrca and J. Scott, "Introduction", in De Búrca and Scott (eds), *Constitutional Change in the EU: from Uniformity to Flexibility* (Oxfod: Hart Publishing, 2000), p. 2.

willingness of the EU legislators to surrender control over the substance of EU law by way of adopting more functional, outcome-oriented and principles-based provisions.

Certainly, from the perspective of Member States, the fact that the EU places rule-making authority within the nascent Eurocracy does not make regulation any more flexible in substantive terms. On the contrary, this increases not only the number of rules but also probably their prescriptiveness. However, within the EU such reorganization and reallocation of regulatory authority does increase procedural flexibility of rule-making and improves the regulator's capacity to invoke centralized, uniform reactions to changed circumstances without overt dependence on legislative activity and the bargaining it entails.

The following two Sections will examine more closely the rule-making powers of the ESMA with the help of two case studies.

Harmonization through delegated law-making: the role of the ESMA

Lifting technical standards to the domain of binding Union law

The ESFS, in combination with the Lisbon Treaty's hierarchy of norms, provides efficient means to achieve uniformity: technical standards can now be issued in the form of binding Union acts. Within its wide and somewhat amorphous mandate[62], the ESMA participates in development of binding delegated acts and implementing acts, which fall under the TFEU category of "non-legislative acts" of general application (arts 290 and 291).

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[62] The ESMA Regulation, rec 9. The mandate under art. 1(2) lists practically the entire set of EU legislation dealing with securities markets but goes even further by including "all directives, regulations, and decisions based on those acts, and of any further legally binding Union act which confers tasks on the Authority." The ESMA can also act in relation to issues not explicitly covered by legislation, such as corporate governance and auditing and financial reporting (art. 1(3)).

First of all, a legislative act can delegate to the Commission the power to adopt delegated acts, i.e. “non-legislative acts of general application to supplement or amend certain non-essential elements of the legislative act”. To preserve institutional balance, the delegating act must explicitly define the objectives, content, scope and duration of the delegation of power. Delegation of power cannot concern essential elements. (TFEU Art. 290(1) and (2)).

More precisely, there are two kinds of delegated act that the ESMA can develop. The traditional way is that the Commission that has been vested with delegated powers specifically invites the ESMA to give technical advice. A formal request from the Commission identifies the basis and boundaries of the request and also reserves the right to revise the mandate if necessary.[63] On these occasions, the ESMA exercises an advisory function by and large similar to that of its predecessor, the CESR.

Alternatively, a legislative act may also directly appoint the ESMA to develop so-called regulatory technical standards. Under this procedure set forth by the ESMA Regulation (arts. 10 to 14) the ESMA’s advisory function turns into something more institutional. Importantly, such a legislative authorisation sidesteps the Commission by depriving it of its power of initiative.[64] Under the special procedure set forth in the ESMA Regulation, the Commission continues to have the power to amend or reject draft ESMA standards, but its powers are

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[63] See e.g. European Commission, formal request to ESMA for technical advice on possible delegated acts concerning the amended Prospectus Directive (2003/71/EC). *http://ec.europa.eu/internal_market/securities/docs/prospectus/esmaadv_en.pdf* [Accessed March 15, 2013].

[64] This difference is emphasized by Eddy Wymeersch who distinguishes between, what he calls “Commission-only” acts and “ESA plus Commission” acts. See E. Wymeersch, “The European Financial Supervisory Authorities or ESAs”, in Wymeersch, Hopt, and Ferrarini (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (2012), pp. 250–251.

subject to constraints, both explicit and implicit.[65] In any event, the Commission cannot intervene without prior coordination with the ESMA.[66]

Notwithstanding this, the ESMA still lacks the legislative mandate. Therefore any direct authorization must be accompanied by a formal delegation to the Commission to adopt the standards as delegated acts.[67] Standards become binding after they are endorsed by the Commission and published in the Official Journal. In addition, delegations of power are subject to safeguard provisions: either the Council or the Parliament can revoke a delegation of power and veto a delegated act adopted by the Commission within a period set by the ESMA Regulation (or a subsequent legislative act).[68] In principle, the delegation of power to the Commission to adopt ESMA regulatory technical standards is limited to four years, but the period extends automatically.[69]

In addition to regulatory technical standards, which can amend or supplement the relevant legislative act, the ESMA can develop implementing technical standards. These are based on the implementing acts procedure under Article 291 TFEU which enables adoption of certain acts to "create uniform conditions for the implementation of legislative acts". Implementing

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[65] The ESMA Regulation goes so far as to suggest that interfering with a draft regulation might happen only under "very restricted and extraordinary circumstances" (rec. (22)). Rec. 23 further states that draft technical standards may be subject to amendment if they are incompatible with Union law, do not respect the principle of proportionality or run counter to the fundamental principles of the internal market for financial services.

[66] The ESMA Regulation, art. 10(1).

[67] However, here the the Commission must observe the procedural requirements set forth in arts 10 to 14 of the ESMA Regulation.

[68] The ESMA Regulation arts 12 and 13. For Robert Schütze the Parliament's enhanced role under art. 290 TFEU amounts, from a democratic point of view, to a "constitutional revolution". See R. Schütze, "'Delegated' Legislation in the (new) European Union: A Constitutional Analysis" (2011) 74 MLR 661, p. 685.

[69] The ESMA Regulation, art. 11.

acts are executive measures in the sense that they cannot amend or supplement the act in question.[70] The development of implementing technical standards under the ESMA Regulation (art. 15) follows a similar procedure to the development of regulatory standards but with a significant difference in that the Council and Parliament are not allowed to intervene.[71]

Whether binding technical standards will be developed and adopted as delegated acts or implementing acts depends solely on the authorizing provision in the relevant legislative act. In legislative vernacular the power to adopt delegated acts is "delegated" whereas the power to adopt implementing acts is "conferred".

Case 1. Shareholders' disclosure regime

The Transparency Directive[72] establishes a minimum level of transparency with regard to major shareholdings in Europe's public companies. It requires that shareholders notify the issuer when the amount of shares held reaches, exceeds or falls below certain thresholds. The prevailing transparency regime was originally premised on close connection between shareholders' economic and voting interests. However, equity derivatives and similar financial instruments have made it possible to "decouple" voting rights from economic ownership (e.g. right to receive dividends). And because disclosure rules usually address

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[70] Though implementing and delegating acts are mutually exclusive Union acts, it is not always easy to distinguish them in substantive terms. P. Craig, *EU Administrative Law*, 2nd ed. (Oxford University Press, 2012), pp. 134–35.

[71] These executive measures are exercised and controlled under the updated comitology regime, i.e. by the Member States through representative committees. See Regulation 182/2011 laying down the rules and general principles concerning mechanisms for control by Member States of the Commission's exercise of implementing powers [2011] OJ L 55/13.

[72] Directive 2004/109/EC, OJ L390/38 (as amended).

voting power rather than economic interest, the latter may not always be disclosed to issuers and markets.[73] In other words, depending on the position, an investor could hold voting power in the company without having a corresponding economic interest, or vice versa. In 2010 the issue of "hidden ownership" was put forward by the CESR, which expressed increasing concern at potential use of certain financial instruments in acquiring or exercising undisclosed influence in a listed company or allowing for creeping control.[74]

In line with the issues raised by the CESR and the proposal it put forward, the Commission proposed in 2011 a modification of the Transparency Directive with the aim of extending the substantive scope of the shareholders' disclosure regime.[75] In the final version of the Directive the definition of financial instruments was extended to all instruments "with similar economic effect" to holding of shares and entitlements to acquire shares.[76] The change was needed to ensure that in spite of innovative financial instruments issuers and investors continue to have full knowledge of the structure of corporate ownership.[77] Newer

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[73] H.T.C Hu, "Hedge funds, insiders, and the decoupling of economic and voting ownership: Empty voting and hidden (morphable) ownership" (2007) 13 *Journal of Corporate Finance* 343.

[74] In effect, the CESR was concerned that a significant degree of *de facto* control could be exerted indirectly via the voting rights attached to shares held as a hedge against long economic exposures created by certain derivative instruments. CESR, Proposal to extend major shareholding notifications to instruments of similar economic effect to holding shares and entitlements to acquire shares CESR/09-1215b, p.6.

[75] Proposal for a directive amending Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and Commission Directive 2007/14/EC COM(2011) 683 final.

[76] Under art. 13(1)(b) of the revised Transparency Directive 2013/50/EU the notification requirements shall apply to a natural person or legal entity who holds, directly or indirectly financial instruments which are referenced to shares falling under the provision's scope (art. 13(1)(a)) and which have similar economic effect to those shares, whether or not they confer a right to a physical settlement.

[77] Directive 2013/50/EU, Rec. (9).

definition was designed to capture any present or future derivative positions that are referenced to listed shares.

Pros and cons of the reform have been listed elsewhere.[78] For the purposes of this article, the adopted "economic effect" test provides a good example of a more flexible regulatory approach where open-ended legislative provisions are adopted to increase the capacity of the regulatory regime to react to changed circumstances. With a shift of focus from a legal form of a financial instrument to its economic effect, the regulator would no longer rely on legislative activity to balance the check brought about by an innovative financial instrument. However, at the same time this formula exposes the legal certainty trade-off that such open-ended provisions entail: it would be difficult for a market participant to anticipate which financial instruments are considered, from the regulator's point of view, as having the required economic effect. If the issue was left solely to the discretion of national regulators, or alternatively to be judged *ex post* by national courts or competent authorities in enforcement actions, the regime would most likely suffer from inconsistency. Again, the issuers and holding companies could opt for the loosest regime.

To mitigate problems of uncertainty and diversity, the Directive provides that the ESMA shall establish and periodically update an indicative list of financial instruments that are subject to notification requirements taking into account technical developments on financial markets.[79] Such a list would not be legally binding (hence "indicative") and it is not entirely

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[78] For a critical perspective, see D. Zetzsche, "Against Mandatory Disclosure of Economic-only Positions Referenced to Shares of European Issuers – Twenty Arguments against the CESR Proposal" (2010) 11 EBOR 231.

[79] Directive 2013/50/EU, art. 9(b)(1a)(2)(a) and (b). In the original proposal the Comission was delegated the power to explicitly specify by way of a delegated act which kind of financial instruments would have been considered as having the required economic effect. In the final version this provision was dropped.

clear how it would be maintained, but in practice the list will likely provide important guidance. However, the ESMA shall develop also draft regulatory technical standards to specify the cases where certain exemptions are applicable as well to specify the methods for calculating the number of voting rights in certain specific cases.[80]

The regulatory technique applied in the modified Transparency Directive is not an isolated case. For instance, under the European Market Infrastructure Regulation (EMIR)[81] the ESMA develops standards for determining the classes of derivatives that should be subject to the clearing obligation (art. 5).[82] The ESMA also exercises substantial discretion in determining the preconditions for extraterritorial reach of EMIR, which is to apply to certain contracts entered into between non-EU entities, but which are considered to have a "direct, substantial and foreseeable effect" within the Union, or where it is necessary to prevent regulatory arbitrage (art. 4(4)). The ESMA's standards pursuant to Prospectus Directive[83], as amended, also concern many non-technical matters, perhaps most far-reaching being the power to develop draft regulatory technical standards to specify "situations where a significant new factor, material mistake or inaccuracy relating to the information included in the prospectus requires a supplement to the prospectus to be published" (art. 16).[84]

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[80] Directive 2013/50/EU art. 9(d)(4)(2)) and 9(b)(1b)(2).

[81] Regulation 648/2012 of 4 July 2012 on OTC Derivatives, Central Counterparties and trade repositories [2011] OJ L 201/1.

[82] Rec. 16, Regulation 648/2012 ("On the basis of draft regulatory technical standards developed by ESMA, the Commission should decide whether a class of OTC derivative contract is to be subject to a clearing obligation[…]").

[83] Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC [2003] L 345/64

[84] Omnibus I Directive, art. 5(7).

Convergence through non-binding instruments

Interpretative authority of the ESMA non-binding guidance

Unlike the ESAs' powers to develop binding technical standards, which are somewhat circumscribed, their power to issue non-binding guidelines and recommendations is much less regulated.[85] In many respects, the ESMA's soft law powers are in substance similar to those of its forerunner the CESR.[86] The CESR's activities in the context of supervisory convergence developed organically and resulted in an impressive amount of non-binding guidance.[87] Because of their *de facto* legal effects, CESR guidelines and recommendations were described as quasi-binding or even as a secondary source of law.[88] The CESR itself held that its non-binding measures might have indirect legal effects, *inter alia*, through their interpretative force or by way of creating legitimate expectations with a view to increasing the predictability of the competent authorities' actions.[89]

The ESMA continues to have the power, at its own initiative and within its substantive mandate, to issue guidelines, recommendations, opinions, and other convergence instruments. These can be formulated as general and declaratory comments or, alternatively,

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[85] Busuioc, "Rule-Making by the European Financial Supervisory Authorities: Walking a Tight Rope" (2013) 19 E.L.J. 111.

[86] The CESR's power to issue non-binding guidance was formally recognized only in 2009 by the Commission Decision 2009/77/EC (art. 3).

[87] Moloney, "The Committee of European Securities Regulators and level 3 of the Lamfalussy Process" in Tison, De Wulf, Van der Elst, Steennot (eds), *Perspectives in Company Law and Financial Regulation: Essays in Honour of Eddy Wymeersch* (2009). pp. 451–457.

[88] T.M.J. Möllers, "Sources of Law in European Securities Regulation – Effective Regulation, Soft Law and Legal Taxonomy from Lamfalussy to de Larosière" (2010) 11 EBOR 379, p. 385.

[89] CESR, MiFID Level 3 Expert Group Workplan for Q4/2007 – 2008, CESR/07-704c.

be addressed directly to competent authorities or financial market participants. None of these instruments are legally binding (i.e. enforceable), but their effect is bolstered by an explicit "comply-or-explain" regime: the competent authorities and financial market participants are under an explicit statutory obligation to make every effort to comply with ESMA guidelines and recommendations.[90] The authorities must always notify the ESMA whether they intend to comply with them or, alternatively, state reasons for non-compliance.[91] The ESMA's ability to publish the stated reasons for non-compliance provides a gentle pressure mechanism. Furthermore, if specifically required by a guideline or recommendation, also financial market participants must report whether they are compliant.[92]

The ESMA Regulation states that the purpose of ESMA non-binding acts is to promote common and efficient supervisory practices and contribute to uniform and consistent application of EU law (art. 16(1)).[93] This implicitly confers on the ESMA a degree of interpretative authority. The fact that Member States often had their own different interpretations of the same legal texts was one of the key deficiencies that the ESFS was designed to overcome.[94] The following case study illustrates with a recent example how the ESMA pursues this goal with the help of interpretative authority conferred on it.

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[90] The ESMA Regulation, art. 16(3)(1).

[91] The ESMA Regulation, art. 16(3)(2).

[92] The ESMA Regulation, arts. 16(3)(3) and 16(4).

[93] A similar provision was included in the Commission decision of 6 June 2001 establishing the Committee of European Securities Regulators [2001] OJ L191/43.

[94] The ESMA Regulation, rec. (8).

Case 2. Defining the key concepts of the AIFMD

Implementation of the directive on alternative investment fund managers ("AIFMD")[95] provides a good example of how post-legislative determination of the exact scope of EU law might not always be preserved for binding acts or courts.

The AIFMD extends EU regulation of investment funds to alternative investment funds such as hedge funds and private equity, which have remained largely unregulated at the EU level. The directive's scope is wide as it is designed to cover management of all kinds of investment funds not regulated by the UCITS[96] regime and concerns all funds irrespective of their legal structure or the manner in which they are established (e.g. statute, contract, trust).[97] This broad objective risks the scope of the directive becoming over-inclusive as there are arguably investment funds that are not alarming from the perspective of investor protection or systemic risk. The AIFMD acknowledges this by presenting certain specific carve-outs (art. 2(3)) and quantitative threshold exemptions (art. 3). However, it is the definition of alternative investment funds (AIFs) that is crucial for determining the Directive's personal scope because the Directive applies generally to all AIF managers, which are defined as "legal persons whose regular business is managing one or more AIFs".[98] That said, Article 4(1)(a) defines AIFs as non-UCITS collective investment undertakings (including their investment compartments), which raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors.

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[95] Directive 2011/61/EU [2011], O.J L174/1 (AIFMD).

[96] Directive 2009/65/EC [2009], OJ L302/3.

[97] AIFMD, rec. (3).

[98] It should be noted that the Directive does not regulate AIFs as such but only their managers.

The definition of AIF, though relatively conclusive in its basic objectives, includes undefined and open-ended terms such as "investment policy" and "raising capital" which could be interpreted inconsistently in different jurisdictions. This could cause some variance in the exact scope of the Directive's application and open possibilities for legal arbitrage. The ESMA's intervention seeks to avoid this. Pursuant to direct authorization in the AIFMD (art. 4(4)), the ESMA has prepared regulatory technical standards concerning the types of AIFM covered by the directive. However, the ESMA determined after consultations that technical standards should only comprise limited issues[99] while most matters would be better resolved in the form of guidelines. The final guidelines on "key concepts" of the AIFMD was issued in August 2013.[100]

The guidelines aim to ensure common, uniform and consistent application of the concepts included in the definition of AIF.[101] It sets out clarification as to terms such as "raising capital", "collective investment", "number of investors" and "defined investment policy", each term being directly extracted from the above stated definition of "AIF" in the legislative text. According to the ESMA, these definitions of key concepts should be taken

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[99] The final draft regulatory technical standard by the ESMA concerns only clarification as to differentiation between AIFMs managing closed-ended AIFs and/or open-ended AIFs. ESMA, Final Report: Draft regulatory technical standards on types of AIFMs. ESMA/2013/413. It is particularly interesting that the Commission decided not to endorse the standards, but invited ESMA to resubmit them with certain amendments on the basis the first draft "risks not be fully compatible with the AIFMD". The ESMA has given its formal opinion on the matter. 2013/ESMA/1119 (13 August 2013).

[100] ESMA Guidelines on Key Concepts of the AIFMD.

[101] ESMA Guidelines on Key Concepts of the AIFMD, p. 6.

into account in determining whether or not an entity falls under the definition of AIF, and therefore within the scope of the AIFMD.[102]

Rather than going into the detail of the individual definitions, it is important here to note that it is not unusual for the scope of EU securities regulation to be determined by non-binding guidelines or other "convergence tools". The choice not to incorporate the majority of the scope-related issues in binding standards might be justified from the perspective of both proportionality and subsidiarity, but what is interesting is that this decision was seemingly within the ESMA's discretionary powers.

The use of a soft law instruments in implementing the AIFMD is not an isolated case either. The ESMA regularly provides interpretative guidance with respect to complex definitions adopted in legislative texts. Another recent example of such an exercise of quasi-authoritative interpretation is the ESMA guidelines on the scope of exemption for market making activities and primary market operations under the Short Selling Regulation.[103] On the other hand, abundant guidance documents adopted by the CESR remind how this phenomenon was an established practice well before the establishment of the ESFS and the ESAs.[104]

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[102] ESMA Guidelines on Key Concepts of the AIFMD, p. 7.

[103] ESMA, Guidelines: exemption for market making activities and primary market operations under Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of Credit Default Swaps, ESMA/2013/74 (2 April 2013).

[104] On the advanced level 3 regime adopted in the context of market abuse, see Moloney, "Innovation and Risk in EC Financial Market Regulation: New Instruments of Financial Market Intervention and the Committee of European Securities Regulators" (2007) 32 E.L. Rev. 627, pp. 655–658. To name one good example, see CESR, MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements, CESR/09-559 (3 November 2009).

Discussion: striking the limits of flexibility

The above analysis showed different techniques by which the scope and content of EU financial legislation can be made more adaptable to changed circumstances. One technique is embedded in the TFEU framework of "non-legislative acts" (TFEU arts 290 and 291). Although the ESAs lack powers to adopt formal laws of general application, the legal status of binding technical standards is clear. There is nothing quasi-legal in delegated acts or implementing acts adopted by the Commission – both are directly applicable Union acts. Soft law instruments provide another technique that can also increase flexibility, but in a more elusive way. First, they do not require formal legislative mandates or Commission invitations. Secondly, soft law brings flexibility through its ambiguous legal status. These techniques and their respective limits and challenges will be assessed next.

Doctrinal and legal boundaries of delegation

An efficient system of delegated legislation presupposes a body of legislation that delegates meaningful power to the Commission and the ESAs to act as subordinate regulators. A review of recently adopted EU financial legislation indicates that the practice of delegating regulatory power to the Commission has become widespread especially in the area of financial regulation.[105] For instance, at the time of writing this article, the Commission had already adopted nine technical standards and two delegated acts under the EMIR alone. The AIFMD provides an extreme example, as the directive delegates or confers to the Commission the power to adopt delegated acts or implementing acts in more than fifty different provisions. While most measures concern highly technical issues, delegated acts

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[105] See S. Peers and A. Costa, "Accountability for Delegated and Implementing Acts after the Treaty of Lisbon" (2012) 18 E.L.J. 427, p. 427.

also include contentious issues such as corporate governance, risk management and general principles concerning operating conditions.[106]

The rationale for increased presence of non-legislative acts is simple if viewed against the background of the EU single rulebook policy. The ESMA Regulation refers to a need to "introduce an effective instrument" to achieve the single rulebook.[107] By lifting most technical standards to the realm of binding acts, the scope of uniformity is significantly expanded. Because standards are adopted as regulations, the problem of divergent transpositions is avoided. Delegating regulatory authority to the EU administration also increases flexibility of the regulatory system. In identifying areas of existing legislation that would be suitable for new kinds of binding standard, the Commission stated expressly that technical standards were needed in areas where it would be important to have flexibility to respond rapidly to market developments or have the option to do so in the future.[108]

However, despite the clear link between the TFEU and the ESAs' binding technical standards, certain procedural aspects render their normative relationship problematic. The ESAs' Regulatory technical standards are somewhat alien to the TFEU framework for "ordinary" delegated acts because of the additional constraints on the Commission's power. In practice, these constraints are largely offset by several limitations on the ESMA's regulatory powers. Nevertheless, the Commission has been concerned at limitations on its authority in adoption of regulatory standards, expressing repeatedly serious doubts as to

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[106] Commission delegated regulation (EU) No 231/2013 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision [2013] OJ L 83/1.

[107] ESMA Regulation, rec. (22).

[108] Flexibility was one of the five high-level principles guiding the Commission's elaboration. See Proposal for Omnibus I Directive, (COM(2009) 576), p. 5.

whether these restrictions are in line with arts 290 and 291 of the TFEU.[109] But beyond this, constitutional problems concerning new forms of delegation are surrounded by awkward silence.[110]

Another important aspect of delegation is the range of issues delegated acts and implementing acts can comprise. Implementing acts are executive acts, which cannot amend legislation but only facilitate their implementation.[111] Delegated acts, on the other hand, are quasi-legislative in the sense that they can amend or supplement the non-essential parts of legislative acts. This requirement also concerns the ESA regulatory technical standards, which are adopted as delegated acts.[112] But the fact that technical standards are developed by an ESA, a Union agency, raises additional limitations. Any delegation of power to the ESAs must conform to general judicial safeguards established for rule-making by European agencies. The principle rooted in the *Meroni* decisions by the European Court of Justice prohibits a delegation to agencies of wide discretionary powers involving policy choices.[113] In subsequent jurisprudence *Meroni* has stood for a constitutional non-delegation

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[109] See e.g. Proposal for a directive establishing a framework for the recovery and resolution of credit institutions and investment firms, COM(2012) 280 final, para. 4.4.16.

[110] The few inter-institutional discussions that have been held remain mostly undisclosed to public See P. Schammo, ”The European Securities and Markets Authority: Lifting the Veil on the Allocation of Powers” (2011) 48 CML Rev. (2011) 1879, 1895p. 1895–1899.

[111] See Commission, Implementation of Article 290 of the Treaty on the Functioning on the European Union, COM(2009) 673 final, at 4.

[112] Determination of ”essentiality” in the case law of the European Court of Justice is dominated by *in casu* assessments instead of more constructive, systematic approaches. See M. Chamon, “How the concept of essential elements of a legislative act continues to elude the Court. Parliament v. Council” (analysing *European Parliament v. Council of the European Union* (C-355/10), September 5th 2012) (2013) 50 C.M.L. Rev. 849.

[113] *Meroni* v *High Authority* (*Meroni*) (C-9/56 and C-10/56) [1957-8] ECR 133 and 157, p. 152.

doctrine.[114] Though it may well be questioned whether jurisprudence more than fifty years old should be considered as a sufficient foundation to justify limits on European agencies' powers[115] the case law of the EU courts evidences that "*Meroni* remains good law".[116]

A recent case *UK v Parliament and Council* decided by the Grand Chamber of the European Court of Justice confirmed that *Meroni* principles continue to limit delegation of discretionary powers to the EU agencies.[117] Importantly, however, the Court confirmed for the first time that the institutional framework established by the TFEU, in particular the enhanced judicial safeguards, expressly permits Union agencies to adopt acts of general application.[118] The case did not concern the ESMA's role in developing non-legislative acts of general application (arts 290 and 291 TFEU) or its soft law powers, but rather its power to issue individual decisions of temporary effect but which are also generally applicable.[119]

Meroni requirements are acknowledged also in the regulations establishing the ESAs. The scope of technical standards must be delimited by the legislative acts on which they are based and the delegated power should only concern purely technical issues. All strategic

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[114] Schütze, "Delegated Legislation in the (new) European Union: A Constitutional Analysis" (2011), 74 *Modern Law Review* 661, p. 675.

[115] E. Chiti, "An Important Part of the EU's Institutional Machinery: Features, Problems and Perspectives of European Agencies" (2009), 46 C.M.L. Rev. 1395, p. 1422-1424.

[116] Griller and Orator, "Everything Under Control? The 'way forward' for the European agencies in the footsteps of the Meroni Doctrine" (2010) 35 E.L. Rev. 3, p. 21.

[117] *United Kingdom v Parliament and Council* (C-270/12), January 22, 2014

[118] *United Kingdom v Parliament and Council* (C-270/12), para. 65.

[119] The court stated that the measures contested are generally applicable because they "may also include rules affecting any natural or legal person who has a specific financial instrument or specific class of financial instruments or who enter into certain financial transactions." *United Kingdom v Parliament and Council* (C-270/12), para. 64.

decisions or policy choices should be made in legislation.[120] Finally, the non-delegation principle gains further strength if taken beyond questions of EU institutional balance and viewed as a principle deriving from constitutional principles common to all Member States.

By limiting material discretion that can be delegated to the Commission (and even more so to the ESAs), the existing delegation doctrine sets outer substantive boundaries for the development of more flexible EU financial legislation. The more substantive and non-technical that binding technical standards become, the harder they will be to accommodate within the framework of EU primary law and general principles of EU law.

Given the Treaty constraints, the majority of delegated acts are likely to remain technical. Another possible result of the more formalistic delegation doctrine could be that substantive decisions requiring exercise of discretion are increasingly made on the quasi-regulatory level of ESA guidelines and recommendations, the issuance of which is neither dependent on formal delegations. Guidelines and recommendations are neither subject to the mandatory review by the Commission or the legislators' veto-powers. But as the regulatory weight of EU agencies increases, their unregulated flexibility and lack of procedural constraints are meeting increasing demands for enhanced controls.

Limits of soft convergence

The other regulatory technique identified above promotes convergence and adaptability through instruments that fall under the category of soft law acts. The standard definition of soft law provides that it encompasses rules of conduct, which in principle lack legally

[120] The ESMA Regulation, art 10(1).

binding force but which may have practical effects.[121] As a regulatory technique, soft law is post-legislative in the sense that it aims to provide general guidance on the proper interpretation and application of *existing* EU law.[122]

Because of its expressly non-binding status, the effectiveness of ESA guidance instruments rests largely on them being incorporated into the national regimes of the Member States by their own competent authorities. In that regard, their success continues to be limited.[123] Even when the guidance is adopted, different Member States can transpose them in various ways.

But even if ESA recommendations, guidelines, Q&As, opinions and other such acts are quasi-regulatory at best, that does not mean that they are legally irrelevant. EU case law has granted soft law acts an explicit interpretative function.[124] This article cannot address all the complexities and uncertainties of giving (indirect) legal effect to EU soft law.[125] But it is generally agreed that the term non-binding does not equal absence of legal effects, though

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[121] F. Snyder, "The Effectiveness of European Community Law: Institutions, Processes, Tools and Techniques" in T. Daintith (ed), *Implementing EC Law in the United Kingdom: Structures for Indirect Rule* (John Wiley & Sons, 1995), p. 64

[122] See Senden, "Soft Post-Legislative Rulemaking: A time for More Stringent Control" (2013) 19 E.L.J. 57, p. 60 (also on the need to differentiate between interpretative acts and decisional acts).

[123] See ESMA, "ESMA finds divergence in national supervision of money market funds", press release, ESMA/2013/475 (15 April 2013).

[124] The possibility of soft, post-legislative measures to create indirect legal effects was expressly verified by the European Court of Justice in the seminal case *Grimaldi*, where the Court held that the Commission's non-binding recommendation may constitute a duty for national courts to take it into consideration to the extent the recommendation could clarify the meaning of Union law. *Grimaldi v Fonds des maladies professionnelles* (C-322/88) [1989] ECR 04407. See also Senden, "Soft Post-Legislative Rulemaking: A time for More Stringent Control" (2013) 19 E.L.J. 57, p. 62.

[125] See L. Senden, *Soft Law in European Community Law* (Hart Publishing, 2004).

the nature and extent of the legal effects of EU soft law requires case-by-case assessment and contextual analysis.[126]

From the point of view of flexibility, it is important to note that many advantages of soft law are brought about by its inherent ambiguity, which allows soft law to escape the dualistic black-and-white dichotomy of law and non-law. Paradoxically, because soft law is less concrete, it can be harder to circumvent. The ESMA guidelines on key concepts of AIFMD again provides an apt example: while determining the directive's scope by way of defining some of its key concepts, the guidelines specifically state that competent authorities and market participants should not consider that the absence of any one of the stated characteristics would conclusively demonstrate that an undertaking *does not* fall under the scope of the AIFMD. The guidelines therefore only "illustrate and explain in more detail the characteristics *likely to lead to an undertaking being considered an AIF*".[127] Such an approach leaves discretion to national authorities to revise the scope if necessary and, importantly, makes gaming by the market participants around the directive more difficult.

Soft post-legislative instruments benefit the regulated community by alleviating legal uncertainty. It provides necessary information on the scope of vaguely drafted legal provisions or "framework" norms. But whilst being informative, in the absence of agreement on, or established procedures for determining, the legal effects of soft law instruments or their admissibility to judicial review, soft law may also create a more fundamental kind of uncertainty. Such uncertainty concerns who can dictate the content of EU law and under what circumstances should various soft law acts give rise to observable

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[126] Scott, "In Legal Limbo: Post-Legislative Guidance as a Challenge for European Administrative Law" (2011) 48 C.M.L. Rev. 329, pp. 331–332.

[127] ESMA Guidelines on Key Concepts of the AIFMD, p. 4 (emphasis added).

legal rights and obligations. To that end, a more formalistic approach could enhance legal certainty. But in the post-Lisbon Union, the asymmetry between procedural requirements for adopting binding Union acts (including non-legislative acts of the Commission) and non-binding administrative measures seems to be increasing rather than decreasing.[128]

Genuine rule-making agencies are alien to the EU administration and, absent a Treaty revision, continue to be so. But there are at least two ways to "harden" soft law without giving it a status as hard law. One is facilitating their judicial review, which in principle turns a soft measure into a hard one.[129] The other is subjecting their adoption and promulgation to similar procedural requirements as binding rules and regulations. These two methods are also linked, in that treating soft law acts procedurally as law-like can increase the probability of Courts reviewing them and assigning them indirect legal effect. The Court usually prefers substance to form.

That being said, the future of EU soft law seems much harder than its past: there is rising awareness that the lack of controls and safeguards for EU soft law, both *ex ante* and *ex post*, is untenable given its increasing practical and legal relevance. Principles of democracy, now an important part of the TEU (title II), call for more transparency, legitimacy, participation and predictability in the realm of informal rule-making. In particular, the lack of established minimum procedural guarantees has been identified as the key problem of EU

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[128] As professor Chiti observes, the adoption of binding implementing rules is becoming more proceduralised, whereas adoption of soft law measures still remains informal. Chiti, "European Agencies' Rulemaking: Powers, Procedures and Assessment" 19 E.L.J. (2013) 93, p. 104.

[129] Snyder, "The Effectiveness of European Community Law: Institutions, Processes, Tools and Techniques" in T. Daintith (ed), *Implementing EC Law in the United Kingdom: Structures for Indirect Rule* (1995), pp. 65–66.

administration and a case is increasingly being made for “constitutionalising” the different forms of EU rule-making.[130]

ESA guidelines, recommendations and other convergence instruments seem to operate largely outside the Treaty framework. However, in drafting them the ESAs must, “where appropriate”, follow procedures that are similar to those it is bound to follow in drafting binding technical standards. The measures can include open and public consultations, stakeholder consultations, and cost-benefit analyses[131] and they must be proportionate in relation to the scope, nature and impact of the guidelines or recommendations.[132] The ESA regulations further provide that all decision-making should be bound by Union rules and general principles on due process and transparency.[133] Procedural constraints to the ESA’s soft law function are somewhat vague but logical in a symmetrical sense: the adoption of non-binding instruments is subject to non-binding procedural requirements. In its Public Statement of Consultation Practices, the ESMA has underlined the need to uphold a flexible

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[130] See e.g. D. Curtin, H. Hoffman and J. Mendes, “Constitutionalising EU Executive Rule-Making Procedures: A Research Agenda” (2013) 19 E.L.J. 1; Senden, “Soft Post-Legislative Rulemaking: A time for More Stringent Control” (2013) 19 E.L.J. 57; O. Mir-Puigpelat, “Arguments in Favour of a General Codification of the Procedure Applicable to EU Administration – Briefing Note” (2011), European Parliament, Policy Department C: Citizen’s Rights and Constitutional Affairs (PE 432.776).

[131] ESMA’s Public Statement of Consultation Practices (ESMA/2011/11) clarifies the principles and practices followed by ESMA in consultations.

[132] ESMA Regulation, art 16(2). ESMA must also consult a specific Securities and Markets Stakeholder Group on its actions concerning guidelines and recommendations, when they do not concern individual financial market participants (Art. 37(1)). The Securities and Markets Stakeholder Group is composed of 30 members, representing financial market participants, their employees’ representatives, consumers, academics, and representatives of SMEs. The ESMA Regulation art. 37(2).

[133] The ESMA Regulation, rec. (51).

and proportionate approach to consultation practices that can be adapted according to the issue at hand.[134] Binding standards for pre-adoption procedures could thus jeopardise some of the procedural flexibility of the ESMAs' post-legislative rule-making.

More generally, the fact that "better regulation" principles must already be taken into account when the ESAs' non-binding instruments are developed speaks more generally for the increasing acknowledgement of their regulatory role. Their recognized importance is perhaps best revealed by the fact that ESA guidance must be adopted by a qualified majority decision of the Board of Supervision; draft binding technical standards must meet the same requirement.[135] The European Parliament has also called for the treatment of ESA guidance to be "as binding as possible on national supervisory authorities".[136]

Even if EU soft law-making remains highly informal, its flexibility is not completely unregulated, but principles-based. Soft law acts do not provide a range of suitable interpretations for the courts and authorities to invoke unilaterally whenever their content meets their own needs and predispositions. The principles of legal certainty and legitimate expectations provide obvious safeguards in this respect. On the other hand, compliance with the letter of guidelines and recommendations should neither be perceived as an absolute safe haven for regulated firms, i.e. if they clearly contradict binding rules. Indeed, determination of legal effects of soft law continues to require difficult balancing between high-level, hard

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[134] ESMA, Public Statement of Consultation Practices (ESMA/2011/11).

[135] The ESMA Regulation, art. 44(1). As a rule, decisions are made by simple majority.

[136] European Parliament, Report on the proposal for a regulation of the European Parliament and of the Council establishing a European Banking Authority, Committee on Economic and Monetary Affairs, (3 June 2010). (Rapporteur: José Manuel García-Margallo y Marfil).

principles.[137] The demands for increasing control of EU administrative rulemaking nevertheless signal a departure from a principles-based model towards a more formal regime.

Finally, increasing demands for formalising EU soft law could be viewed as reflecting a form of synthesis. It is widely acknowledged that the rules and regulations often push financial entities to move their activities and assets outside the regulatory perimeter.[138] But the above analysis has indicated that the EU regulator's role in this regulatory dialectic is more complex than is often presumed. Regulatory innovation goes beyond drafting laws and regulations, and involves above all innovative regulatory practices, procedures and instruments. Such dimensions also form the essence of several New Governance approaches and other fashionable regulatory techniques. But as the EU rule-maker moves further away from traditional, constitutionally mandated and constrained, legislative procedures, it is important to remember that the use of public authority is equally constrained by laws and procedural rules.[139] Therefore, creative compliance might not be a vice of just those subject to rules, but also very much of rule-makers themselves.

'New' mode of governance: selected trade-offs

The article has assessed the ability of the EU's current institutional and regulatory architecture to meet the challenging target of combining flexibility with a more integrated single financial market and a uniform rulebook. The "EU approach" thus stands for

[137] O. Stefan, "European Competition Soft Law in European Courts: A Matter of Hard Principles" (2008) 14 E.L.J. 753.

[138] See European Commission, *Shadow Banking – Addressing New Sources of Risk in the Financial Sector* COM(2013) 614/3 (provisional version).

[139] This kind of regulatory fragmentation seems to be characteristic of administrative rule-making in modern states more generally. See Türk, "Oversight of Administrative Rulemaking: Judicial Review" (2013) 19 E.L.J. 126, p. 126.

increased control but also for the ability to react to developments that can neither be foreseen nor controlled by the regulator.

In structural or procedural terms, the ESFS seems to carry the potential of increasing the ability of EU regulators to adapt the scope of financial laws and prompt concerted efforts in reaction to alarming market developments. In terms of substance, however, it is the quality and nature of level 1 legislation and the scope of delegating provisions thereunder that determine much of the system's capacity. The analysis of the article has been positive in the sense that it has largely avoided more general and normative questions of governance as well as particular questions about the rationale behind the post-crisis policy choices. In the following some of these issues will be addressed.

The EU has not been immune to the influence of so-called new governance approaches to regulation. After the turn of the millennium, it was even argued that the EU polity was undergoing a paradigm change where "uniformity, homogeneity, and one-directional integration" was being replaced by flexibility and differentiation.[140] In retrospect, however, such reports on paradigm change seem greatly exaggerated. Beyond rhetoric and certain established experiments (notably the Open Method of Co-ordination), central tenets of New Governance has failed to penetrate the mainstream EU policy and law-making.[141] In financial regulation, the Lamfalussy process certainly promoted more network-based and perhaps even experimentalist regulatory techniques. It also facilitated the use of soft law regulatory instruments. But at the same time the process started to shift rulemaking and

[140] De Búrca and Scott, "Introduction", in De Búrca and Scott (eds), *Constitutional Change in the EU: from Uniformity to Flexibility* (2000), p 2.

[141] T. Idema and R. D. Kelemen, "New Modes of Governance, the Open Method of Co-ordination and Other Fashionable Red Herring" (2006) 7 *Perspectives on European Politics and Society* 108.

supervision from national to multinational level.[142] Most importantly, Lamfalussy principles never really embraced diversity as an ideal, but rather proved ineffective in eradicating it.

Granted, emphasis is still placed on networks and horizontal governance forms particularly in the area of supervisory coordination. The ESAs' Boards of Supervisors consist of representatives of Member States' competent authorities who can therefore influence decision-making directly. Moreover, better regulation principles such as consultations and cost-benefit analyses continue to be a regular feature of rules preparation and they increasingly concern non-binding measures. What is more, growing resort to soft law instruments reflects the importance of more flexible rule-making structures or "hybrid instruments" advocated by many new governance strategies. These elements are not recent inventions even in the EU.[143]

Yet the post-crisis architecture of EU financial regulation is hardly constructed with the ideals of "experimentalist governance" in mind, in the sense that it would be the role of the Member States and their subnational bodies to adapt EU level framework norms to their own circumstances.[144] For example, the ESAs' soft law measures are meant to promote consistent approaches to supervision, even if they tolerate a degree of divergence. Under the

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[142] See E. Posner, "The Lamfalussy Process: Polyarchic Origins of Networked Financial Rule-Making in the EU" in Sabel and Zeitlin (eds), *Experimentalist Governance in the European Union: Towards a New Architecture* (Oxford: Oxford University Press, 2010), pp. 43–60.

[143] Better Regulation principles played an important part already in the Lamfalussy process. European Commission, The Application of the Lamfalussy Process to EU Securities Markets Legislation: A preliminary assessment by the Commission services, SEC(2004) 1459, para. 3.3.

[144] F. Sabel and J. Zeitlin, "Learning from Difference: The New Architecture of Experimentalist Governance in the EU", in Sabel and Zeitlin (Eds) *Experimentalist Governance in the European Union* (OUP, 2010), pp. 1–28, at 4.

ESFS, the legal effect of ESA guidance *vís-a-vís* national authorities is bolstered by a shadow of hierarchy brought about by the ESAs' enhanced ability to take direct measures against national supervisors. The UK's recent challenge of such powers in the European Court of Justice failed.[145] Indeed, the regulatory structure laid down by the ESFS is anything but horizontal, and ideals such as experimentalism and diversity are pretty much the antithesis of the EU's prevailing single rulebook policy.

However, it is also the more hierarchical, top-down regulatory structure and the pursuit of control that provide the source of most significant risks and trade-offs. It is indeed a legitimate question if the prevailing one-size-fits-all approach is feasible or even desirable given the diversity of supervisory cultures and their respective idiosyncrasies.[146] Procedural flexibility and maximum harmonization are certainly not a panacea for the governance of financial markets and choices made involve trade-offs. *First,* in terms of policy-making and legislation, reallocation of regulatory power risks having unintended and counter-productive consequences. The ESFS, with the ESAs acting as more independent regulatory agencies, absorbs and concentrates regulatory authority vertically *vis-à-vis* Member States, but also fragments power within the EU in horizontal terms. Viewed against the dynamics of EU regulatory federalism this development risks further adding to the level of detail of regulatory measures. Evidence suggests that horizontal fragmentation of power within the Union supports the production of highly detailed rules, which constrain severely Member

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[145] *United Kingdom* v *Parliament and Council* (C-270/12).

[146] See e.g. Black, "Restructuring Global and EU Financial Regulation: Character, Capacities, and Learning" in Wymeersch, Hopt, Ferrarini (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (2012), pp. 18, 32; M. Andenas and I. H.-Y. Chiu, "Financial Stability and Legal Integration in Financial Regulation" (2013) 38 E.L. Rev. 335.

States' discretion.[147] Indeed, from the perspective of Member States, the EU financial regulation will not be too flexible.

Second, keeping delegated measures technical and detailed appears desirable from the point of view of democratic legitimacy and accountability. But such a regulatory structure, together with the single rulebook policy, also entails an important choice in terms of governance in that it turns much of the rule-making into an administrative, technical enterprise leaving little to be determined *ex post facto*.[148] Technical and detailed regulations also effectively eliminate discretion of the Member States' competent authorities, whose ability to exercise supervisory judgement is diminished where not abolished. This risks national supervision becoming "mere administrative functionaries".[149] Where a more centralized supervisory structure can be more effective in imposing rules for the entire single market, it can bind the hands of national authorities too tightly and be inefficient in reacting to Member States' specific needs.

Third, simple procedural flexibility cannot escape all the problems of regulatory regimes based on rigid and inflexible rules. Shorter half-life of rules leads to a rulebook that is detailed, thick and complex. Though it is often held that prescriptive rules can provide certainty and consistency in application better than vague principles, they also suffer from

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[147] R. D. Kelemen, "The Structure and Dynamics of EU Federalism" (2003), 36 *Comparative Political Studies* 184 and R. D. Kelemen, *The Rules of Federalism: Institutions and Regulatory Politics in the EU and Beyond* (Cambridge and London: Harvard University Press, 2004).

[148] James J. Park has used the term "administrative paradigm" to describe these kinds of rulemaking systems. See J. J. Park, "The Competing Paradigms of Securities Regulation" (2007) 57 *Duke Law Journal* 627, p. 663.

[149] Ferran, "Understanding the New Institutional Architecture of EU Financial Market Supervision" in Wymeersch, Hopt, and Ferrarini (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (2012), pp. 142–144.

over and under-inclusiveness, gaps, and rigidity.[150] An effective system of delegation must allow post-legislative fine-tuning in order to increase modifiability of rules. That may diminish the problems of inclusiveness, but does not escape the underlying dilemma of dialectic feedback patterns: Persistent adapting and transforming of rules result in a "mountain of exceptions and patchwork regulations", the effects of which the market, in turn, seeks to mitigate or circumvent.[151] In theory, given the regulators' enhanced ability to plug loopholes, rent-seeking might be limited to techniques that can generate profits relatively easy and demand little resources.

The *fourth* problem is that the post-crisis tidal wave of legislative initiatives and various implementing measures represent a significant compliance burden for an increasing number of regulated firms. Simple frustration might have the effect that "tick the box" approaches prevail over regulatory dialogues.[152] A closely associated risk is that the relationship between the regulator and the regulated can become more adversarial rather than less so.

Finally, the development faces obvious political uncertainties. Games having power and sovereignty at stake are often zero-sum in nature. Therefore, as the federalising regulatory structure arms EU rule-makers with important powers, it at the same time diminishes the

[150] For a succinct pros/cons account of rules and principles, see J. Black, M. Hopper, C. Band, "Making success of Principles-based regulation" (2007) 1 *Law and Financial Markets Law Review* 191. Theoretical discussions are well summarized in Ford, "New Governance, Compliance, and Principles-Based Securities Regulation" (2008) 45 *American Business Law Journal* 1, pp. 6–10 and D. Awrey, "Regulating Financial Innovation: A More Principles-Based Proposal" (2010) 5 *Brooklyn Journal of Corporate, Financial and Commercial Law*, 273, pp. 274–281.

[151] As described by Frank Partnoy in the context of derivatives: F. Partnoy, "Financial Derivatives and the Cost of Regulatory Arbitrage" (1996-1997), 22 *The Journal of Corporate Law* 211, pp. 249–250.

[152] See Black, Hopper, and Band, "Making success of Principles-based regulation" (2007) 1 *Law and Financial Markets Law Review* 191, p. 195.

discretion of national regulators and makes their future role more uncertain. The development is unlikely to remain as incremental and linear even if far-reaching steps have recently been taken in the context of Banking Union project.

Concluding remarks

In analysing the development of EU financial rule-making, this article adopted a perspective that looks beyond the one-dimensional, substance-focused notion of EU law as an occupant of a single continuum with complete uniformity at one end and flexibility at the other.[153] It is unquestionable that the prevailing single rulebook policy, and the maximum harmonization agenda it embraces, leave less room for flexibility in terms of discretion left for the Member States. Delegated and implementing acts adopted by the Commission are directly applicable Union acts and most of their provisions are excessively detailed and technical. As such they arguably represent a step towards rigorous uniformity but with no flexibility. But ever since the beginning of the Lamfalussy process, the demand for another kind of regulatory flexibility has become more visible in the development of EU financial law: the prevailing conventional wisdom is that increasingly complex and unpredictable financial markets require laws and regulations that are preferably more adaptable and revisable than more diverse. Such procedural flexibility is not so much concerned with the level of detail of rules but rather with (a) the existence of an effective system of delegation and (b) supportive EU legislation that leaves sufficient amount of detail to be filled on lower levels of regulation.

With regard to (a), the article concludes that the ESFS, leveraged by the TFEU system of delegated law-making, seems to have the required flexibility in procedural terms. However,

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[153] G. De Búrca and J. Scott, "Introduction", in De Búrca and Scott (eds), *Constitutional Change in the EU: from Uniformity to Flexibility* (2000); J. Scott, D.M. Trubek, "Mind the Gap: Law and New Approaches to Governance in the European Union" (2008) 8 E.L.J. 1, p. 4 (note 2 and accompanying text).

this flexibility is over-shadowed by a number of constitutional and legitimacy problems of which the article touched upon a few: the somewhat uneasy normative relationship between the ESAs' technical standards and the TFEU provisions on non-legislative acts (Arts 290 and 291) as well as the limits which the constitutional non-delegation doctrine imposes on discretionary powers of the ESAs.

With regard to (b), the non-exhaustive analysis made above does not enable the deduction of the direction of a general trend. But as noted, there are good examples of more open-ended, functional and outcome-oriented provisions that allow post-legislative perimeter control via the nascent EU financial administration. The modified shareholders' disclosure regime under the revised Transparency Directive serves as an ideal type.

Finally, much of the convergence of EU financial law continues to be coordinated by post-legislative soft law instruments issued by the ESAs. With most technical standards lifted to the domain of binding Union law, the ESAs' role as quasi-authoritative interpreters of EU financial law probably becomes more visible. Determination by the ESMA of the key concepts of the AIFMD with non-binding guidelines is a telling example. Such explicit impositions of interpretative authority are unlikely to go unnoticed in Member States.[154] Moreover, the highly informal nature of EU soft law has raised demands for setting minimum standards for pre-adoption procedures and better access to courts. While better safeguards would bring EU soft law more firmly in line with the EU constitutional principles, creeping formalism can deprive the ESAs of some of their rule-making flexibility.

[154] For instance, the Finnish Ministry of Finance in its e-letter to the Parliament raised concerns over conceptual innovations made by the ESMA in its AIFMD guidelines as well as their de facto effect on national discretion. VM2013-00130, 21 February 2013, p. 4 (in Finnish only).