KEY POINTS

- The European Commission's proposals for a "Capital Markets Union" and for an "Investment Plan for Europe" aim to create a "Single Market" within the EU by removing regulatory barriers across jurisdictions.
- The House of Lords report on the post-crisis financial regulatory framework provides a set of recommendations for enhancing the cooperation between the UK and EU financial services policy making process, and underlines the role of international *fora* on capital sector regulation.
- The "Capital Markets Union" represents a necessary step to secure harmonisation of securities law and to increase consumer and investor protection across Member States. In this regard, the House of Lords report examines the implications for the UK of the current reforms agenda developed at EU level.

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The House of Lords report on the post-crisis EU regulatory framework: where does the UK stand?

This article provides an appraisal of the House of Lords report on the post-crisis financial regulatory framework taking into account the current reforms agenda implemented at EU level.

INTRODUCTION

Europe is still characterised (with the exception of the UK) by bank dominated financial systems. In order to unlock the financing resources for companies and individuals, we need to develop strong and diversified capital markets in the EU. This will help realise the true potential of the single market in financial services.

As a reform agenda to expand the non-bank part of Europe's financial system the Commission launched a set of proposals for a "Capital Markets Union"[1] and for an "Investment Plan for Europe"[2] aiming to establish "a properly-functioning Single Market in capital by diversifying funding and improving investment opportunities across the EU".[3] This new regulatory approach proposes: (i) to mitigate system-wide risks; (ii) to reduce banks' risk-taking incentives; and (iii) to remove regulatory barriers across jurisdictions.[4] The rationale for such reforms is to enhance non-bank credit provision and to make Europe's financial system more efficient and competitive, more resilient thanks to greater diversity, more responsive to monetary policy signals, and more able to respond to the financing needs of a vibrant innovation-driven economy.[5]

The Commission stated that: "the Capital Markets Union (CMU) is a plan of the European Commission that aims to create deeper and more integrated capital markets in the 28 Member States of the EU. With the CMU, the Commission will explore ways of reducing fragmentation in financial markets, diversifying financing sources, strengthening cross border capital flows and improving access to finance for businesses, particularly SMEs".[6]

The main areas of the Green Paper addressing the Capital Markets Union are: (i) improving access to financing for all businesses across Europe and investment projects, in particular start-ups, SMEs and long-term projects; (ii) increasing and diversifying the sources of funding from investors in the EU and all over the world; and (iii) making the markets work more effectively so that the connections between investors and those who need funding are more efficient and effective, both within Member States and cross-border.[7]

The Commission's proposals aim to build a unified European financing system by finding new and innovative ways to channel funds efficiently from those enjoying surplus resources to those best able to make use of those funds.[8] However, a proper pan-European regulation is needed to realise the CMU ambition of development of EU capital markets and non-bank intermediation.

As Véron observed "CMU policy should not seek to freeze market structures in their currently underdeveloped form but, on the contrary, to create a favourable environment for the development of new intermediation segments and new financing contracts, with effective but not excessive safeguards against systemic risk".[9]

Capital markets require transparency, fairness, equal access, competition and investment soundness. In the aftermath of the 2008 global financial crisis, a very strong case can be made for asserting that the securities industry underestimated the value and importance of consumer protection.[10] The inadequate regulation of the securitisation market is a case in point. Retail investors suffered from an evident lack of transparency and information asymmetries, reflecting a fundamental imbalance amongst market participants.[11]

A number of legislative instruments aiming *inter alia* at better consumer protection are part of the EU post-crisis regulatory response to the crisis: the Credit Rating Agency Regulation,[12] the Alternative Investment Fund Managers Directive (AIFMD),[13] the Market Infrastructure Regulation (EMIR),[14] the Capital Requirements Directive IV (CRD IV),[15] the Capital Requirements Regulation (CRR),[16] the Bank Recovery and Resolution Directive,[17] the Markets in Financial Directive,[18] ...

Closer examination of these texts suggests that a central question is how to reduce informational asymmetry in the capital sector and amongst financial actors. One of the principal factors for the growth of the financial markets is the integrity and competence of its members.

This brief article provides an appraisal of the House of Lords report on the post-crisis financial regulatory framework taking into account the current reforms agenda implemented at EU level. Further discussion is devoted to the development of a "Single Market" in which the objectives of lowering costs of funding and removing barriers to cross-border investment constitute potential benefits for the creation of pan-European capital markets.

THE EU REGULATORY STRATEGY FOR THE SECURITIES MARKET

Given the importance of financial markets for the future of the EU and the devastating consequences of inadequate design and supervision – as evidenced by the twin financial and sovereign debt crisis in the eurozone – the need for adequate regulation of financial markets and institutions has become a cornerstone of the EU's policy strategy in recent years. First the Financial Services Action Plan (FSAP),[20] then the Lamfalussy Report followed by the De Larosière Report[21] with the establishment of a European System of Financial Supervision for the EU as a whole,[22] comprising the European Supervisory Authorities or ESAs (European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Funds Authority (EIOPA)) and the European Systemic Risk Board (EBRD) and, more recently, the European Banking Union.[23] In terms of substantive rules, a large *corpus* of financial directives addressing the reform of the securities markets has been enacted or proposed in response to the global financial crisis and its impact upon the EU. These rules address the need for enhanced consumer protection while safeguarding financial stability, but are also aimed at redressing the incomplete integration of financial markets, which still hampers the creation of a true single market in the EU.

The need to remove the existing national barriers between Member States is a key rationale underlining the MiFID directive,[24] widely considered as the centrepiece of the FSAP. However securities regulation in the EU still requires further harmonisation.

A common set of rules at the international level is yet to replace local rules and administrative burdens governing cross-border financial activities, with substantial costs still incurred in obtaining permissions, licenses and approvals by the relevant national authorities. In this regard the "soft law"[25] emanating by global regulators such as the Group of Twenty (G-20), the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO)[26] falls short of what globalised securities markets need.[27]

A self-regulation regime[28] characterised by internal controls, best practices, compliance and "treat customers fairly" programmes[29] needs to be complemented by an "outcomes-based regime".[30]

The complexities of the regulatory system result in fragmentation and a diffusion of accountability. In the last few decades, rule-making has been considered to be too slow to keep up with innovation in the sphere of financial instruments (for instance, in the case of derivatives) and has been relegated to the same level as principles, with the inevitable confusion of their respective roles.

Technological innovation and the transformation of the financial markets have brought about major changes in terms of regulation, resulting in different responses and strategies in the EU and in the UK. On the one hand, the EU strategy has laid the foundation for a new way of dealing with the securities sector, which is characterised by consumer protection and an investor-disclosure system.[31] On the other hand, the UK strategy has launched an outcomes-based regime governed not only by rules but also by principles which have to be correctly interpreted.

There are a number of ways in which Europe can replicate the US success in terms of providing easier access to finance, for example via the availability of venture capital for start up firms. This should enhance opportunities for growth and employment. Of course structural reforms are also needed. Key amongst those are the removal of administrative 'barriers' to start businesses in a number of European jurisdictions.[32]

THE HOUSE OF LORDS REPORT ON THE POST-CRISIS EU FINANCIAL REGULATORY FRAMEWORK

In February 2015, the House of Lords published the report "The post-crisis EU financial regulatory framework: do the pieces fit?" containing an oversight of the current reforms launched by the Commission in order to create a common platform for capital sector.[33]

The report sets out a list of recommendations with respect to: (i) the role of the EU institutions; (ii) the role of the European Supervisory Authorities (ESAs); (iii) the EU financial regulatory framework; (iv) the international regulatory agenda; and (v) the implications for the UK. One of the key elements of the post-2008 financial crisis legislative action is the fact that Member States have shown great reluctance to abandon local rules and dismantle normative barriers.

In this regard, the House of Lords observes that the Commission's proposals represent a necessary step to strengthen the "Single Market" and to avoid regulatory arbitrage. However, the weaknesses of the supervisory architecture put in place by the ESAs hampered the need to rethink the regulatory approach for retail financial services. The report notes that these bodies lacked authority, had insufficient independence, and exerted only a marginal influence over the shape of primary legislation, with insufficient flexibility in the correction of legislative errors and inadequate funding and resources. In this respect, appropriate scrutiny and accountability mechanisms can enhance the ESAs' consultation procedures and their engagement with practitioners and regulators. It is essential to develop a more flexible and expedited mechanism whereby the ESAs can improve their function in the law-making process.

A key aim of the "Capital Markets Union" is that it improves consumer and investor protection. Consumers represent a large proportion of financial actors and an adequate regulatory system is needed to protect the "weaker party" to business transactions. A lack of understanding of the complexity of the financial sector and its interconnections was a key factor in the scale and depth of the 2007-2009 global crisis. The report recognises the efforts of the Commission's proposals to strengthen consumer protection: however, detailed disclosure requirements are unlikely to benefit consumers. In this respect, "Capital Markets Union" provides an ideal opportunity for addressing securities law, reviewing the Prospectus Directive and considering the role of crowdfunding as a funding tool.[34] It is recommended that "the impact of the new regulatory framework on the retail market should accordingly be carefully monitored by national regulators and the ESAs".[35]

A pan-European securities market poses new challenges in terms of legal analysis and regulation strategy. On the one hand, the concept of harmonisation permits the administrative costs of the duplication of provisions (ie, home country and host country rules) to be reduced, thus favouring cross-border financial transactions. On the other hand, the introduction of the "Single Market" allows for a flexible and innovative framework in which capital markets, as an alternative to bank funding, assume a pivotal role in the functioning of the EU economy.

Above all, an innovative regulatory framework should be accountable to investors with flexibility to adapt to changing markets and clarity of responsibility to interact with international counterparts. Members' reputation will be a chief factor in enhancing market confidence, because it is only if there is clear accountability between participants that it will be possible to improve a fiduciary relationship in the financial markets. The House of Lords underlines the need to enhance the transparency and comparability of financial assets to allow international, European and national competent authorities properly to regulate and supervise financial institutions, providing confidence to financial market participants and end users.[36]

In this vein, it is possible to argue that the road to achieve a harmonised system of financial markets must presuppose a strong regulatory structure in terms of supervisory convergence and coordination at the international level. The road towards securities market integration seems to exhibit the same contours as the monetary integration which culminated in the achievement of the single currency.

ENHANCING THE RELATIONSHIP BETWEEN EU AND UK FINANCIAL REGULATION (OFTEN IN IMPLEMENTATION OF EU LAW)

The UK Government wants London to remain a global financial centre. It also wants it to continue to play a fundamental role in the functioning of Europe's capital markets. The challenge for the UK is that the eurozone has embarked on a process of centralisation of supervision and crisis management in the banking sector, that may eventually "spread" to other areas of the financial sector. While the UK remains committed for the time being to the Single Market the UK has no desire to be part of banking union and no appetite for further transfer of sovereign powers in the financial arena.

Though the UK favours the establishment of an EU-wide capital markets union, issues of jurisdictional domain lurk in the background.

One of the Commission's fundamental goals in the area of securities regulation is legislative harmonisation. A "Capital Markets Union" aims to create a single system for cross-border transactions with an efficient integration of securities products in which market participants are clearly accountable for their acts.

The "Capital Markets Union" proposals do not lay down specific rules regarding enforcement; this function is delegated to the network of cooperation within the EU institutions, which has to monitor firms' behaviours and create strong incentives to reduce the risk of confidence failures.

The implementation of the post-crisis EU financial legislation has determined an innovative change in terms of transparency and responsibility to consumers: in this context, the "Capital Markets Union" proposes a new common ground of provisions, while adopting a practical and flexible approach to rule-making. It can be observed that all rulemaking bodies commit to regulatory self-restraint which is consistent with the principles of better regulation.[37]

The EU financial reforms are characterised by investor protection measures reflecting a manifest preoccupation with consumers and their expectations. Consumers cannot be neglected as "persons with little financial clout", but rather must be regarded as an essential parameter of judgement for the whole financial sector.

Questions of legitimacy and accountability are linked to the utmost degree with consumer protection policy.[38] Market confidence is a key objective in terms of investor protection. Legitimate and accountable regulation prevents the potential risk of confidence failure and promotes a clear understanding of consumer protection law, correcting imbalances of information between producers and consumers of financial services.

Financial regulatory convergence requires a number of tools in order to ensure proper disclosure and adequate accountability on the part of the supervisory authorities. In order to establish an efficient regulatory structure, the EU institutions should develop an effective and constructive dialogue with the UK authorities which will entail more efforts to enhance the monitoring function. Greater supervisory convergence in EU securities markets will enhance the benefits of a true "Capital Markets Union".

The House of Lords report makes it clear that the Single Market remains a fundamental driver of growth across the EU and is thus of demonstrable benefit to the UK economy. As stated by the report, "given the UK's leading position, the development of the Single Market in financial services is a key determinant of the continued prosperity of the UK financial sector".[39] In this way, the UK Government supports improving the strength of the EU regulatory architecture and is committed to the Single Market in financial services.

CONCLUSIONS

The reforms agenda launched by the Commission within the Green Paper on "Capital Markets Union" has changed the regulatory strategy of the EU financial sector. The Commission aims to build a true "Single Market" for capital on the basis of the following objectives: (i) improving access to finance for all businesses and infrastructure projects across Europe; (ii) removing barriers to cross-border investments; (iii) ensuring an effective level of investor protection; and (iv) reducing the cost of raising capital.

Following the 2007-2009 financial crisis, the self-regulation law-making process characterised by management choice and market participants' actions (eg, intermediaries conduct and senior management responsibility) has come under scrutiny. The crisis revealed the distortions involved in managing securities products, and altered the prevailing sentiment with regard to regulatory approaches questioning the predictability of the market actors (managers, shareholders, stakeholders).

The concepts of predictability, legitimacy, accountability and certainty constitute the benchmarks of an efficient market where consumer confidence and investor protection are fundamental elements of transparent behaviour. Further harmonisation of legal systems and a more integrated financial sector are the necessary corollaries of a viable "Capital Markets Union". ■

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15 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

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18 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

19 Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

20 The Lamfalussy structure was inserted into the EU Financial Services Action Plan (FSAP) adopted by European Commission in 1999. The Lamfalussy regulation was characterised by four levels of rules: level one consisted of principle-based legislation, adopted as before under the co-decision procedure; level two consisted of detailed implementing measures, consisting either of Commission directives or regulations, made under powers conferred by the Level 1 directive, under a new streamlined accelerated legislative procedure, in which the Commission is assisted by the European Securities Committee and the Committee of European Securities Regulators (CESR); level three ensured cooperation between the members of CESR concerning proper implementation of level

Biog Box

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one and level two measures; level four concentrated on more effective enforcement of compliance with EU legislation. See Rosa M Lastra, "The governance structure for financial regulation and supervision in Europe" (2003) 10(1) *Columbia Journal of European Law*, 62-63; Niamh Moloney, "The Lamfalussy Legislative Model: A New Era for the EC Securities and Investment Services Regime" (2003) 52(2) *International and Comparative Law Quarterly*, 512-513; Eilís Ferran, *Building an EU Securities Market* (Cambridge: CUP 2004) 55 and 125-126.

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25 Soft law signifies a form of non-binding rules constituted by legal opinions, statements, guides, protocols, and commentaries. These forms have no legal force, but can influence the Courts and market participants. See Rosa M Lastra, *International Financial and Monetary Law* (Oxford: OUP 2015) Chapter 14. See also Chris Brummer, *Soft Law and the Global Financial System, Rule Making in the 21st Century* (Cambridge: CUP 2012) 74.

26 Global regulators are generally considered "informal regulators", there is no formal legal framework that govern the responsibilities and the division of labour among them. These entities and bodies are involved in the process of setting international standards for financial markets commonly defined as a form of "soft law". See Mario Giovanoli, "A New Architecture for the Global Financial Markets: Legal Aspects of International Financial Standard Setting" in Mario Giovanoli (ed), *International Monetary Law. Issues for the New Millenium* (Oxford: OUP 2000) 33.

27 David Rouch, "Self-regulation is dead: long live self-regulation" (2010) 4(2) *Law and Financial Markets Review*, 103.

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31 Niamh Moloney, *How to protect investors. Lessons from the EC and the UK* (Cambridge: CUP 2010) 104.

32 As the FT editorial of 25 March 2015 "Europe is a waiting room thronging with the sick" noted: "Starting a business can take months and the finance for growth is hard to obtain. In Italy it is normal to wait four years for a contract to be enforced. In France [and I would add in Spain, too], the heavily protected profession of notary rusts up the wheels of commerce".

33 House of Lords, "The post-crisis EU financial regulatory framework: do the pieces fit?", European Union Committee, 5th Report of Session 2014-15, 2 February 2015, 5.

34 Ibid. 94.

35 Ibid. 52.

36 Ibid. 10.

37 See the 2014 EU Commission "Economic Review of the Financial Regulation Agenda" and the 2014 EU Parliament report "Enhancing the coherence of EU financial services legislation".

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