

EU Financial Supervision: a new framework

In response to the financial crisis, the structure of the European financial supervisory system has been overhauled. The EU institutions have agreed to enhance and further integrate the financial supervisory framework to include both macro- and micro-prudential oversight. The new framework will become operational by 1 January 2011. Although the national supervisors will continue to oversee the activities of financial institutions operating in their jurisdictions, the reforms will create an additional layer of EU supervision and will give greater powers to EU bodies to coordinate and apply harmonised rules. These reforms represent a significant step change in the way that responsibilities and powers are divided between national and EU supervisors.

Levels of supervision: what will change?

Macro-prudential supervision

The **European Systemic Risk Board (ESRB)** is being created to supervise the financial system as a whole. This level of oversight has not existed previously at the EU level and has been introduced to prevent and limit widespread financial distress.

The ESRB will have three main tasks:

- to monitor and assess systemic risk;
- to provide early warnings when significant risks emerge; and
- to issue policy recommendations for remedial actions and monitor their implementation.

The ESRB's warnings and recommendations will be addressed to the EU Council, individual Member States or groups of Member States, the three new European Supervisory Authorities (discussed in detail in the next section), or national supervisors. However, the ESRB will not have binding powers to impose measures. Nevertheless, the ESRB will exert significant influence and the bodies to which it issues recommendations will be

obliged to take action or provide reasons for not following its recommendations.

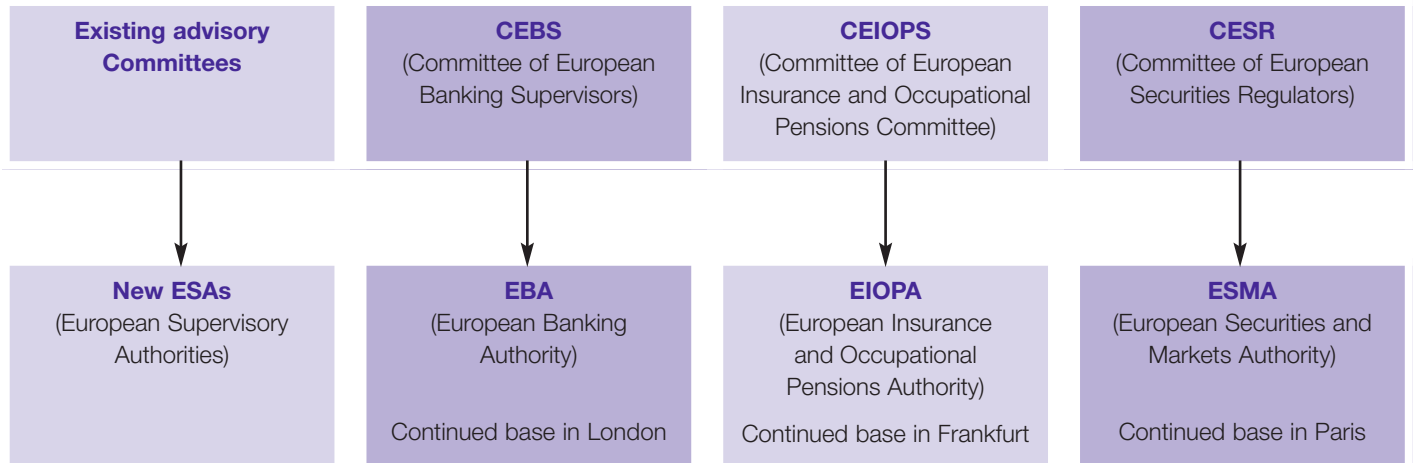
One important feature of the ESRB will be the level of central bank involvement in its governance. The ESRB will be based in Frankfurt and it will be chaired by the

President of the European Central Bank (ECB) for an initial 5-year term. The ECB will also oversee the day-to-day running of the ESRB and will provide staff and support for its operations. In addition, the Governors of each Member State's central bank will sit on the General Board.

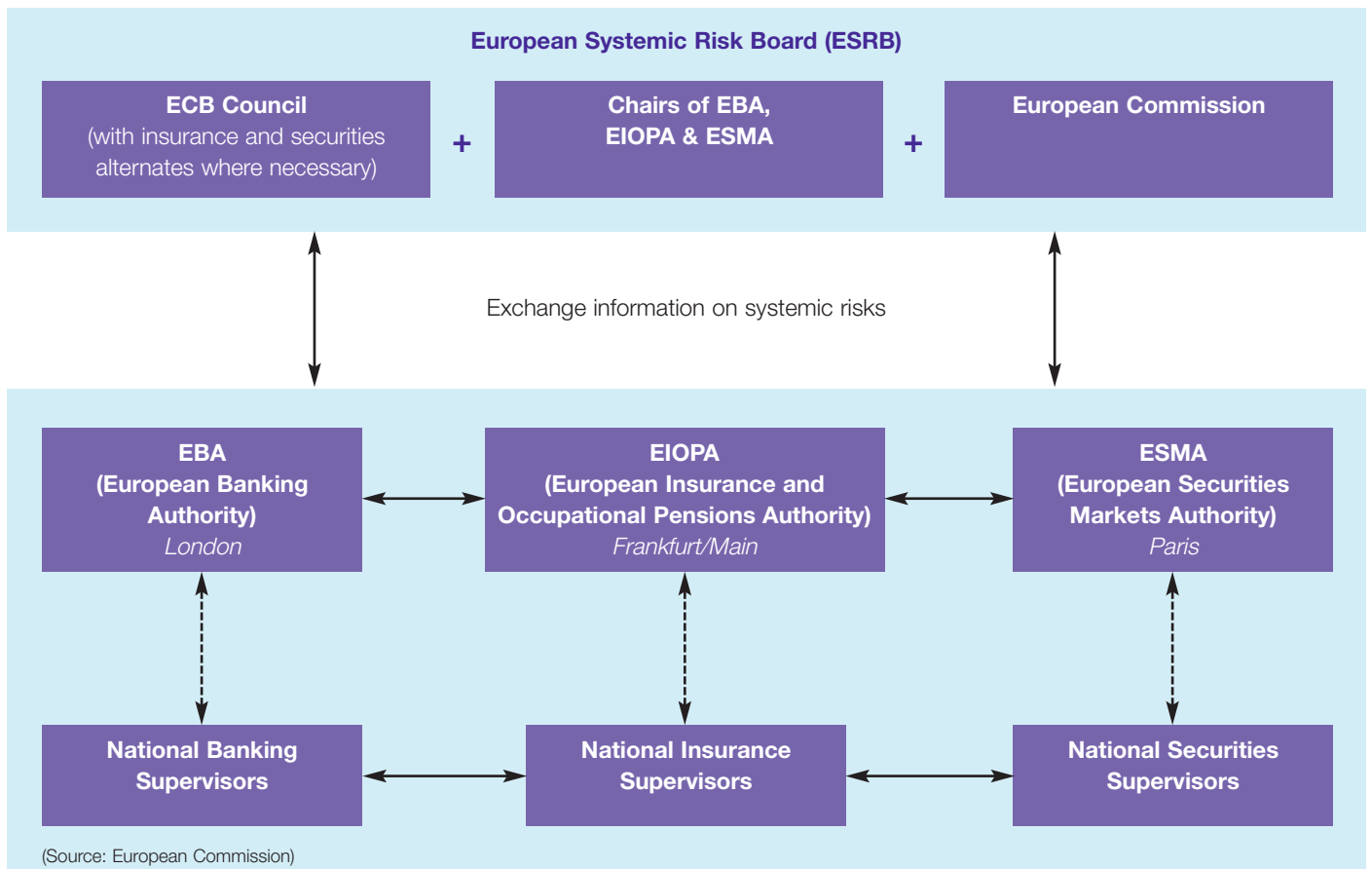


Micro-prudential supervision

A **European System of Financial Supervisors (ESFS)** is being established to supervise individual financial institutions, sit across financial markets and intervene in crises. The ESFS will include three **new European Supervisory Authorities (ESAs)**, which will be created by transforming the existing advisory “Level 3” Committees into Authorities:



The ESAs will work in tandem with the Member States’ supervisory authorities, although daily supervision of individual firms will remain with the national authorities. In addition, the national authorities will retain the involvement they had with the old Committees by having representation in the new ESAs. The European Commission has described the new system as a “hub and spoke” network of EU and national bodies working together.



(Source: European Commission)

The new ESA powers

The most significant aspect of the new ESAs' powers is a stronger involvement in the European legislative and rulemaking process.

Secondary legislation and the single European rulebook

Once primary, Level 1, legislation (a directive or regulation) has been agreed, additional steps are often needed to give it effect. Traditionally, in the financial services sector, this was achieved by the European Commission adopting secondary, Level 2, legislation and the old

Committees producing related Level 3 guidance. This process will continue to exist once the new financial supervisory framework is in place, but the main purpose of the Committees' transformation into Authorities is to give the ESAs additional power to create legally binding technical standards – a sort of "Level 2+" power.

The intention is for the ESAs to fulfil their "Level 2+" function by creating a single, harmonised, European rulebook applicable to all national authorities and financial institutions in the Single Market. They will maintain the old Level 3 function

by issuing guidelines and recommendations.

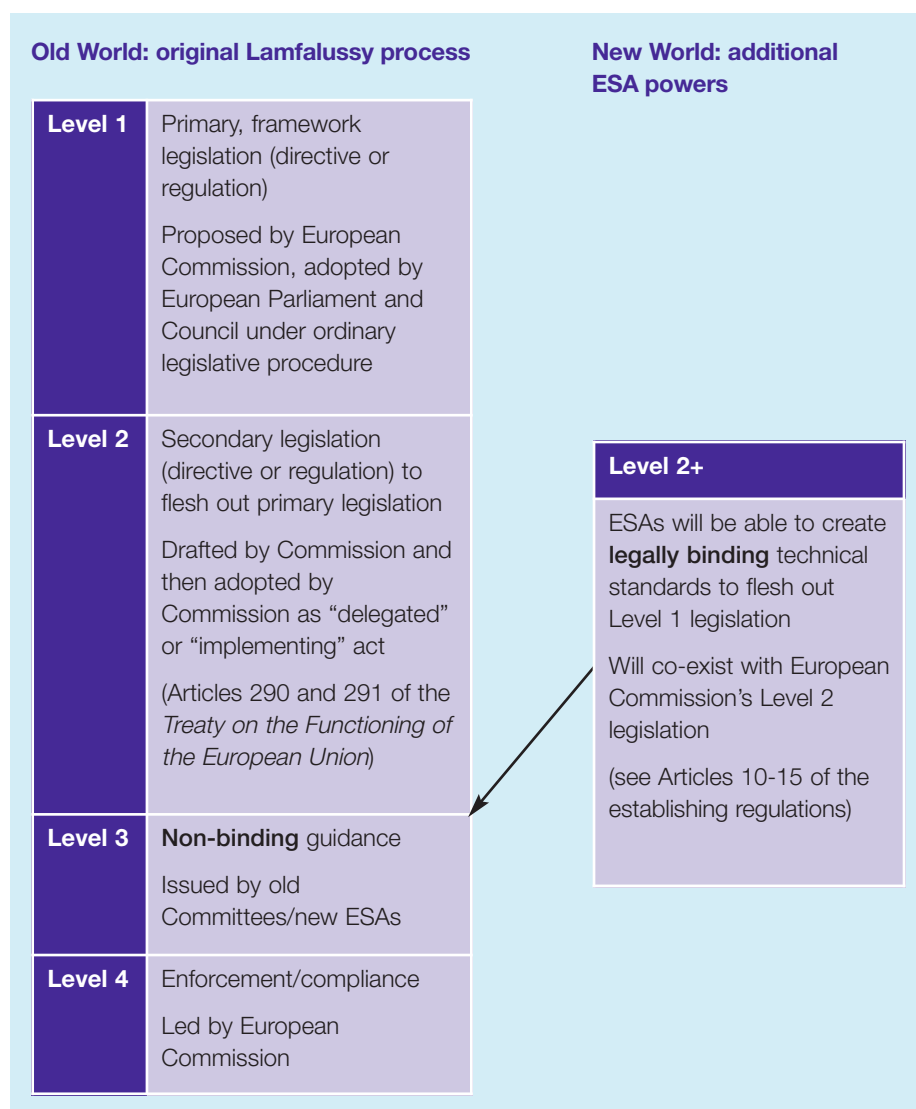
In addition, the ESAs will have the power to monitor how rules are being enforced by Member States' supervisory authorities. Also, if a national regulator refuses to apply EU law, the ESAs will have the authority to by-pass the national regulator and directly impose enforcement on firms.

How will the ESAs create technical standards? Will they consult?

The regulations that have been adopted to establish each of the ESAs outline the steps they must take to create legally binding technical standards.¹

There are two types of standards: "regulatory technical standards" and "implementing technical standards". Both types of standards will be created by a somewhat similar process which can be described briefly as follows:

- the ESAs will hold public consultations and seek opinions from relevant stakeholder groups (e.g. ESMA will seek opinions from the ESMA Securities and Markets Stakeholder Group);
- the ESAs will draft the standards and submit them to the European Commission, which will either endorse, amend, or reject the standards;
- for regulatory technical standards, the European Parliament and Council will have the right to completely reject a standard (they will not have this power for implementing technical standards); and
- once the process is complete, the standards will be adopted as a "Regulation" (which is binding in its entirety and directly applicable in all Member States) or as a "Decision" (which also has direct effect and is binding in its entirety on the persons, entities or Member States to which it is specifically addressed).



¹ Articles 10-15 of each ESA regulation outline the process.

The Commission will have considerable involvement in various stages of the process, from the drafting stage to the adoption stage.

Why are some Level 2 measures being given to the European Commission and others to the ESAs?

The apportionment of the Level 2 powers between the Commission and the ESAs is one of the more interesting aspects of the enhanced role of the ESAs in the legislative process.

Articles 290 and 291 of the recently enacted Treaty on the Functioning of the European Union, which forms part of the Lisbon Treaty, outline the process for the creation of secondary legislation.

Primary, Level 1, legislation may delegate power to the European Commission to create secondary, Level 2, legislation. The objectives, content, scope and duration of the delegation of power must be explicitly defined in the primary legislation. The Level 2 legislation will take the form of either “delegated acts” or “implementing acts” that do not need to undergo the full legislative process with the European Parliament and the Council. The ESAs, like their predecessor Committees, will have a role to play at this stage, by providing advice on the substance of the Level 2 legislation.

Separately, Level 1 legislation may also delegate specific power to the ESAs to draft legally binding technical standards, as described above. Essentially, this power is intended to give the authorities, who have specific technical expertise, the responsibility to establish harmonised rules.

In short, each of these powers fulfil different purposes. In principle, significant, more complicated, issues will be assigned to the Commission to create secondary legislation, whilst other issues for which harmonisation is required will be assigned to the ESAs.

We have had a glimpse of how this delegation of power might play out with the recently adopted Alternative Investment Fund Managers (AIFM) Directive, the proposed regulation on over-the-counter (OTC) derivatives and the proposed regulation on short selling and credit default swaps. All three texts delegate powers, at various points, to the Commission and to ESMA. These texts give significant and broad discretion to ESMA to exercise its Level 2+ power, whilst they are relatively prescriptive about the scope of the Commission’s Level 2 remit.

One concern is that the ESAs may become the forum for resolving issues that cannot be agreed between the European

Parliament and the Council. In effect, political choices that are too difficult could be delayed to Level 2 and the authorities will become much more powerful. This might also decrease transparency.

Other ESA powers

Emergency situations

The ESAs will have exceptional powers to take action in emergencies, including the banning of certain products or restriction of certain financial activities, such as short selling. However, the EU Council will have the power to declare emergencies, in consultation with the European Commission and the ESRB and, where appropriate, the ESAs.

Dispute resolution

The ESAs will have the power to mediate, arbitrate and enforce their decisions. They will have the power to settle disputes between national authorities, in particular in areas that require cooperation, coordination or joint decision-making by supervisory authorities from more than one Member State. Decisions may be appealed to a joint board of appeal for all three ESAs.

Direct supervision of credit rating agencies

ESMA will be given direct, exclusive supervisory power over credit rating agencies registered in the EU.

If you would like to know more about the subjects covered in this publication or our services, please contact:

London



Chris Bates

T: +44 20 7006 1041
E: chris.bates@cliffordchance.com

Frankfurt



Marc Benzler

T: +49 697199 3304
E: marc.benzler@cliffordchance.com

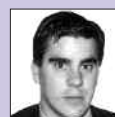
Milan



Lucio Bonavitacola

T: +39 028063 4238
E: lucio.bonavitacola@cliffordchance.com

Madrid



Jose manuel Cuenca

T: +34 91590 7535
E: josemanuel.cuenca@cliffordchance.com

London



Simon Crown

T: +44 20 7006 2944
E: simon.crown@cliffordchance.com

Amsterdam



Frank Graaf

T: +31 20711 9150
E: frank.graaf@cliffordchance.com

Brussels



Yves Herinckx

T: +32 2533 5901
E: yves.herinckx@cliffordchance.com

Luxembourg



Christian Kremer

T: +352 485050 201
E: christian.kremer@cliffordchance.com

Paris



Frederick Lacroix

T: +33 14405 5241
E: frederick.lacroix@cliffordchance.com

Warsaw



Grzegorz Namiotkiewicz

T: +48 22429 9408
E: grzegorz.namiotkiewicz@cliffordchance.com

Prague



Vlad Petrus

T: +420 22255 5207
E: vlad.petrus@cliffordchance.com

London



Dermot Turing

T: +44 20 7006 1630
E: dermot.turing@cliffordchance.com

London

Julia Milosh

T: +44 20 7006 4171
E: julia.milosh@cliffordchance.com

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