TOWARDS A SINGLE CAPITAL MARKETS SUPERVISOR IN THE EU: THE PROPOSED EXTENSION OF ESMA'S SUPERVISORY POWERS

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Abstract: *The EU's post-crisis financial reform agenda has fundamentally altered the framework and approach to the regulation of capital markets in the European Union through the introduction of a single rulebook and the creation of a pan-European supervisory system. Lately, the focus has been on reviewing and optimising the existing policy mix marked by a paradigm shift towards (often maximum) harmonisation of rules for market participants across the Union. Recent EU documents have highlighted the need for strict enforcement of the harmonised regulatory framework and more consistent and centralised supervision to prevent regulatory and supervisory arbitrage and promote equal conditions of competition. The EU regime is not uniformly implemented, as regulatory expertise and resources vary greatly in the Member States. With a few exceptions, EU capital markets and actors therein are supervised at national level. Inadequate supervision in one Member State can be a source of risk for financial market participants and consumers in other Member States. To this end, the European Commission has proposed certain necessary steps for deepening financial integration in the EU, aimed at putting in place as a priority the remaining building blocks for a Capital Markets Union (CMU) by 2019 and, inter alia, creating a single capital markets supervisor. As part of the proposals to strengthen the existing powers of European Supervisory Authorities (ESAs), the European Securities and Markets Authority (ESMA), established as a 'Union body with legal personality' under secondary EU law adopted on the basis of Article 114 TFEU, will receive new direct supervisory powers. This paper offers a look into the proposed measures on reinforcing integrated supervision to strengthen CMU and financial integration in light of potential endogenous and exogenous factors: inter alia, the post-crisis environment, the policy entrepreneurship of both the European Commission and ESMA, and to what extent the latest initiative is incremental – that is, builds on the dynamics or addresses the weaknesses of the existing regulatory and supervisory framework – or might have been driven by external factors, i.e. Brexit.*

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1. INTRODUCTION

The EU's post-crisis financial reform agenda has fundamentally altered the framework and approach to the regulation of EU capital markets through the introduction of a single rulebook for all financial actors in the EU and the creation of a pan-European supervisory network. Lately, the focus has been on reviewing and optimising the existing policy mix marked by a paradigm shift towards (often maximum) harmonisation of rules for market participants across the Union and the need for strict enforcement of the harmonised regulatory framework and more consistent and centralised supervision of capital markets. With a few exceptions, EU capital markets and the actors therein are still supervised at national level. A reinforced supervisory framework for Europe's capital markets is a first new priority to accelerate financial integration and ensure financial stability. To this end, the European Commission has proposed certain necessary steps for deepening financial integration in the EU, aimed at putting in place as a priority the remaining building blocks for a Capital Markets Union (CMU) by 2019 and, *inter alia*, creating a single capital markets supervisor.

This paper begins with a brief analysis of the responsibilities and objectives of the European Securities and Markets Authority (ESMA), which has been created as a regulatory authority, but has been granted direct supervisory powers in cases which are precisely delineated and exceptional, followed by a presentation of the current supervisory state of affairs against the background of the CMU and Banking Union projects. Section 2 briefly outlines the European Commission's latest proposals under the CMU agenda, focusing on the benefits arising from the proposed conferral upon ESMA of direct supervisory powers over an enlarged pool of entities, it examines the rationale behind it, also based on arbitrage risks and finally highlights certain objections that have been put forward against a single supervisor at EU level. It should be noted that any detailed examination of the legal basis included in Article 114 TFEU is beyond the scope of this paper. The final section offers a look into potential exogenous and endogenous factors driving the shift towards more integrated supervision of capital markets proposed by the European Commission.

2. ESMA'S EXISTING MANDATE

2.1. ESMA's responsibilities and objectives

The European Securities and Markets Authority (ESMA) was established under secondary EU law and, more specifically, by means of Regulation (EU) No 1095/2010 (hereinafter the 'ESMA Regulation')[1] adopted on the basis of Article 114 of the Treaty on the Functioning of the European Union (TFEU)[2] as a 'Union body with legal personality' (Article 5 of the ESMA Regulation). Along with the other two European Supervisory Authorities (ESAs), i.e. the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) competent for the banking and insurance and occupational pensions fields respectively, ESMA was created as a regulatory authority in order to help improve the regulatory process in the EU capital markets. ESMA's objectives are set out in Article 1, paragraph 5 of the ESMA Regulation and include preventing regulatory arbitrage and promoting equal conditions of competition (subparagraph (d) thereof).

Under its regulatory hat, ESMA plays a key role in the elaboration of draft technical standards that are adopted, subject to European Commission endorsement, in the form of delegated (regulatory technical standards – RTS) or implementing acts (implementing technical standards – ITS). As the source of technical expertise with extensive empirical and stakeholder consultation capacity in the securities field, ESMA has decisively contributed to the

1 Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EEC and repealing Commission Decision 2009/77/EC, OJ L 331, 15.12.2010, pp. 84-119.

2 The choice of the legal basis is also further clarified in recital 17 of the ESMA Regulation as follows: "The purpose and tasks of the Authority – assisting competent national supervisory authorities in the consistent interpretation and application of Union rules and contributing to financial stability necessary for financial integration – are closely linked to the objectives of the Union *acquis* concerning the internal market for financial services. The Authority should therefore be established on the basis of Article 114 TFEU".

establishment of a European single rulebook for all capital market participants in the EU, by adding a great amount of detail to the legislative measures adopted by the Council and the European Parliament.[3] Apart from the single rulebook, the other main areas of activity under its mandate are supervisory convergence, risk analysis and the direct supervision of specific entities. As regards the latter, it is not the provisions of the above-mentioned Regulation that confer upon ESMA direct supervisory powers over specific entities. Their assignment arises from sectoral legislative acts (see sections 2.2.1-2.2.2 below).

In terms of its responsibility for supervising capital markets at micro-prudential level, ESMA is working within the network of competent supervisory authorities and the ESA Joint Committee. National competent authorities (NCAs) maintain responsibility for direct day-to-day supervision of capital market actors, with a few exceptions (see section 2.2). The EU level, so far, is competent for, and involved in, setting standards and conducting risk assessments for financial market players, as well as ensuring supervisory convergence across the EU by means of soft law measures, i.e. non-binding guidelines, opinions, and Q&As.

Furthermore, it may adopt decisions as legally binding administrative acts addressed to the competent authorities, but it is also entitled to address individual decisions to financial market actors in exceptional and well-defined cases: breaches of Union law,[4] emergency situations, and the settlement of disagreements between competent authorities in cross-border situations, as set out in Articles 17, 18 and 19 of the ESMA Regulation,[5] respectively. Under Article 9(5) thereof, ESMA is also granted direct intervention powers to temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the EU financial system if required in an emergency situation (as set out in Article 18 of the ESMA Regulation)[6] or if provision is made to this

3 For a more detailed analysis of ESMA's regulatory mission, see Deipenbrock, 2016: 19-26, referring, *inter alia*, to ESMA's powers as "quasi rule-making" (p. 21). See also Moloney, 2011b: 41-86.

4 Article 17 of the ESMA Regulation. ESMA's supervisory powers to intervene in cases of breach of Union law belong to level 4 of the Lamfalussy rule-making process, first introduced in 2002 and subsequently amended as a result of the adoption of the Treaty of Lisbon and the ESMA Regulation. For a thorough examination of ESMA's powers under Article 17, see, by way of indication, Gortsos, 2016: 189 et seq.

5 For a detailed analysis of the direct intervention powers conferred upon the ESMA under Articles 17-19 of the ESMA Regulation, see, indicatively, Schammo, 2011: 1885-1890.

6 ESMA Regulation, Article 9(5).

effect in relevant legislative acts. Such a provision can be found in Article 28 of Regulation (EU) No 236/2012 on short selling,[7] which grants ESMA direct powers to intervene in capital markets in exceptional circumstances, i.e. in order to address a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union in case there are cross-border implications, if NCAs have either not taken measures to address the threat or the measures taken do not adequately address the threat.[8] ESMA's direct intervention powers are very precisely specified: they pertain to measures prohibiting or imposing conditions on the entry by natural or legal persons into a short sale or a transaction which creates, or relates to, a financial instrument other than credit default swaps, where the effect (or one of the effects) of the transaction is to confer a financial advantage on such person in the event of a drop in the price or value of another financial instrument.[9] Any such ESMA measures prevail over any previous measure taken by NCAs.[10] It was the above system of ESMA intervention that was challenged by the UK before the Court of Justice of the European Union (CJEU),[11] *inter alia*, on the basis of the *Meroni* doctrine.[12] The CJEU affirmed the powers conferred on ESMA, ruling that the system of ESMA intervention falls within the scope of Article 114 TFEU.[13] However, a survey of the constitutional debate on whether the powers attributed to ESMA are in line with EU law or require Treaty reform lies outside the scope of this paper.

7 Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps, OJ L 86, 24.3.2012, pp. 1-24.

8 Ibid., Article 28(2).

9 Ibid., Article 28(1)(b).

10 Ibid., Article 28(11).

11 Judgment of the Court (Grand Chamber) of 22 January 2014, *United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union* (Short-selling), C-270/12, ECLI:EU:C:2014:18.

12 The *Meroni* doctrine, relates to the extent to which EU institutions may delegate their tasks to regulatory agencies. See Judgment of the Court of 13 June 1958. Cases C-9/56 and C-10/56, *Meroni & Co., Industrie Metallurgiche, SpA v High Authority of the European Coal and Steel Community*, ECLI:EU:C:1958:7 and ECLI:EU:C:1958:8.

13 Avgouleas & Ferrarini (2018: 58) argue that ESMA's standing has been reinforced following the CJEU judgment in the *Short-selling* case (see footnote 11 above).

2.2. ESMA's existing direct supervisory powers

ESMA is currently the only one of the three ESAs, which directly supervises specific entities in the EU, i.e. credit rating agencies (CRAs) (see section 2.2.1 below) and trade repositories (see section 2.2.2 below). On these two types of entities, ESMA is granted a limited number of exceptional discretionary supervisory powers, i.e. direct responsibility for registration and supervision, including the power to impose enforceable financial penalties.

2.2.1. Credit rating agencies (CRAs)

CRAs were the first type of capital market entities to become subject to ESMA's direct supervision in 2011.[14] More specifically, ESMA is competent for the registration and ongoing supervision of credit rating agencies, but NCAs maintain competence for the oversight of users of credit ratings.[15] ESMA has the power to decide whether to register, refuse or withdraw registration of EU-based CRAs on the basis of the requirements stipulated in the CRA Regulation. Such registration is a requirement in order for the users of credit ratings, i.e. credit institutions, investment firms, insurance/assurance/reinsurance undertakings, undertakings for collective investment in transferable securities (UCITS), institutions for occupational retirement provision and alternative investment funds (AIFs), to be able to use CRA ratings for regulatory purposes.[16] ESMA's direct supervisory powers also extend to third country CRAs, for which it is responsible to issue certification decisions after ensuring compliance with the criteria set out in the CRA Regulation and recognising the legal and supervisory framework of the third country in which the CRA is authorised/registered as equivalent to the requirements of the CRA Regulation, ascertaining that the cooperation arrangements between ESMA and the relevant third country authorities are operational and that the credit ratings issued by the CRA and its credit rating activities are not of systemic importance to financial stability or integrity of the financial markets of one or more Member States.[17] ESMA is also granted sanctioning powers, i.e. the right

14 Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 (OJ L 145, 31.05.2011, pp. 30-56, hereinafter 'CRA Regulation') transferred responsibility for the supervision of CRAs from NCAs to ESMA by amending the relevant provisions of Title III (Surveillance of credit rating agencies) of Regulation (EC) No 1060/2009 on credit rating agencies (OJ L 302, 17.11.2009, pp. 1-31).

15 Recital 9 of the CRA Regulation.

16 Article 4(1) of the CRA Regulation.

17 Article 5(1)(b)-(d) of the CRA Regulation.

to withdraw the registration, suspend the use of ratings for regulatory purposes, temporarily prohibit the CRA from issuing credit ratings, and requiring the CRA to bring an infringement to an end, including the power to impose enforceable[18] fines and periodic penalty payments on CRAs, where it finds that they have, intentionally or negligently, infringed the provisions of the CRA Regulation.[19] ESMA's power to impose fines is subject to a very detailed 'two-step methodology', consisting of: (a) the setting of a basic amount, for which maximum and minimum amounts are allocated according to the level of seriousness of the offence,[20] and (b) the adjustment of that basic amount by factoring in certain aggravating or mitigating coefficients linked to the circumstances under which the infringement has been committed (set out in Annex IV of the CRA Regulation). The fine is set at the lower, the middle or the higher end of the basic amount by taking account of the CRA's annual turnover in the preceding business year.[21] It must be pointed out that the CJEU is granted unlimited jurisdiction to review ESMA's decisions to impose a fine or periodic penalty payment, whereby the Court may annul, reduce or increase the fine or periodic penalty payment imposed.[22]

2.2.2. Trade repositories (TRs)

ESMA's direct supervisory powers over trade repositories[23] closely resemble those over CRAs, i.e. they pertain to the registration and ongoing supervision of EU-based trade repositories and the recognition of third-country trade repositories in accordance with the provisions of Title VI of the European

18 Recital 24 of the CRA Regulation states that the enforcement of ESMA decisions imposing fines and periodic penalty payments should be governed by the rules of civil procedure which are in force in the State in the territory of which it is carried out. Rules of civil procedure should not include criminal procedural rules, but it should be possible that they include administrative procedural rules.

19 An exhaustive list of infringements is provided in Annex III of the CRA Regulation.

20 Article 36a(2) of the CRA Regulation. For a discussion of two recent cases, where fines have been imposed by ESMA on DBRS and Fitch Ratings, see Howell, 2017: 1042-1045.

21 Under Article 36a(2) of the CRA Regulation, the lower end of the limit concerns CRAs with an annual turnover below €10 million, the middle of the limit concerns CRAs with an annual turnover between €10 and €50 million and the higher end of the limit is to be imposed on CRAs with an annual turnover of more than €50 million.

22 Article 36e of the CRA Regulation.

23 Trade repositories centrally collect and maintain (for regulatory purposes) the records of all details regarding over-the-counter (OTC) derivatives contracts (such as options and futures contracts) that market participants have entered into in any EU Member State.

Market Infrastructure Regulation (EMIR).[24] ESMA is empowered to adopt a range of supervisory measures, where it finds that a trade repository has committed one of the infringements listed in Annex I EMIR, taking into account the nature and seriousness of the infringement, having regard to well-defined criteria.[25] Such supervisory measures, as set out in Article 73(1) EMIR, include the power to require the trade repository to bring the infringement to an end, to impose fines, which are fixed following a two-step methodology (like in the case of CRAs), to issue public notices, and, as a last resort, withdraw the registration of the trade repository. ESMA's decisions imposing fines and periodic penalty payments are enforceable and their enforcement is subject to the rules of civil procedure[26] which are applicable in the State in the territory of which it is carried out.[27] A review clause providing unlimited jurisdiction to the CJEU also applies to ESMA's decisions pertaining to trade repositories, under Article 69 EMIR.

2.3. The supervisory state of affairs under the Capital Markets Union and Banking Union agendas

In light of the above, NCAs remain the default supervisors for capital market actors as part of the broader European System of Financial Supervision (ESFS), which brings together national and EU supervisory authorities operating on the basis of the home country control principle, which determines the competent supervisory authority, and mutual recognition of the home state authority's supervisory decisions by the host state's authority.[28] As expressly clarified in recital 28 of Council Regulation (EU) No 1024/2013,[29] NCAs

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24 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 2012 on OTC derivatives, central counterparties and trade repositories (hereinafter 'EMIR'), OJ L 201, 27.7.2012, pp. 1-59.

25 As defined in Article 73(2) EMIR, the criteria to be applied are the duration and frequency of the infringement, whether the infringement has revealed serious or systemic weaknesses in the undertaking's procedures or in its management systems or internal controls, whether financial crime has been occasioned, facilitated or otherwise attributable to the infringement, and whether the infringement has been committed intentionally or negligently.

26 Recital 87 EMIR stipulates that rules of civil procedure should not include criminal procedural rules, but could include administrative procedural rules.

27 Article 68(4) EMIR.

28 For a more detailed analysis of the use of the home country control principle in EU financial services, see Lagaria, 2017: 243-256.

29 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287,

remain responsible for the supervision of bodies which are not covered by the definition of credit institutions under Union law. It may be argued that the expediency of a single supervisor for capital markets is strengthened by the dynamics developed by the institutional architecture of the Banking Union, in the context of a Financial Union.[30] The Banking Union has been premised from the outset on the idea of centralised European structures responsible for bank supervision (the Single Supervisory Mechanism (SSM) has been operational since 4 November 2014), resolution (the Single Resolution Board (SRB) has been in full operation since January 2016) and deposit guarantee (proposal for a European Deposit Insurance Scheme (EDIS) pending since November 2015) in euro area member countries and any non-euro area Member States participating in the Banking Union.[31] The latter's architecture has been put in place with a view to deepening the Economic and Monetary Union (EMU). The integrated framework of direct supervision by the SSM of more than 130 systemically important credit institutions has been based on the pooling of sovereignty of euro area Member States in the context of the Banking Union. By contrast, the CMU has a broadly regulatory agenda for the entire EU single market. This agenda may have led to a reorientation of supervision under the ESFS framework, but national authorities still maintain their supervisory competence for capital market actors apart from certain exceptional direct supervision powers granted to ESMA, as discussed in the previous section.

3. THE CASE FOR AND ARGUMENTS AGAINST CENTRALISED SUPERVISION OF EU CAPITAL MARKETS

3.1. The proposed extension of ESMA's powers under the CMU agenda

The proposed comprehensive package put forward by the European Commission on 20 September 2017 reviews the ESFS, notably improving the mandates, governance and funding of the three above-mentioned ESAs and the functioning of the European Systemic Risk Board (ESRB). In more detail, the

29.10.2013, pp. 63-89.

30 See European Commission, "Completing Europe's Economic and Monetary Union – the Commission's contribution to the Leaders' Agenda: Completing the Financial Union", 13 September 2017, available at: https://ec.europa.eu/commission/sites/beta-political/files/completing-financial-union_en.pdf.

31 For more details on the institutional framework governing the Banking Union, see, indicatively, Gortsos, 2017 and Binder & Gortsos, 2015.

reform package includes: (i) a Communication on reinforcing integrated financial supervision, (ii) a proposal amending the Regulations establishing the European Supervisory Authorities (ESAs), (iii) a proposal amending the Regulation establishing the ESRB, as well as two additional proposals amending (iv) some supervisory provisions set out, respectively, in Directives MiFID II / Solvency II and (v) the pending proposal amending the European Market Infrastructure Regulation (EMIR) as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs.[32] The aspects of ESA governance and funding lie outside the scope of this paper, which focuses on the proposed extension of ESMA's supervisory mandate.

As part of the CMU agenda, the transfer of new supervisory powers to ESMA aims at a stronger role for (cross-border) financial markets and thus contributing to a greater diversification of funding, i.e. turning away from the predominance of bank lending channels towards equity funding.[33] More centralised supervision is considered necessary to address the additional risks to financial stability posed by a more market-based system.

Under the current proposals, centralised supervision of certain types of funds with cross-border dimensions (such as European venture capital funds (EuVECA) and European long-term investment funds (ELTIF)) would achieve economies of scale. The extension of ESMA's powers in exceptional and well-defined cases to restrict or prohibit the marketing, sale or distribution of units or shares in undertakings for collective investment in transferable securities (UCITS) or Alternative Investment Funds (AIFs) and fund managers would ensure that intervention powers are applied and interpreted consistently by national supervisors and are enforceable against all financial entities on the market.

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32 Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs (hereinafter EMIR proposal), COM(2017) 331 final. For a detailed analysis of direct ESMA supervision of CCPs and the above EMIR proposal, see Busch, 2018: 35-54.

33 European SMEs receive 75% of their funding from banks; European companies are four times more reliant on banks than American ones. See "Europe's Capital Markets Union: What is the long-term- view?" Speech given by Commissioner Jonathan Hill at the 2015 ECMI Annual Conference, Brussels, 20 October 2015, available at: http://europa.eu/rapid/press-release_SPEECH-15-5870_en.htm.

The same benefits should also be valid for direct supervision of those parts of the wholesale financial markets that have a strong European dimension. In particular, ESMA will be able to directly supervise benchmarks that are deemed to be critical (such as EURIBOR or EONIA) and have the powers to endorse non-EU benchmarks that are used in the EU. The European Commission has also proposed centralised authorisation and supervision of data reporting services providers to ensure that data on transactions in financial instruments reported to regulators and the EU markets have the same quality and reliability. A reinforced coordinating role is proposed for ESMA in cases of market abuse and the right to act under certain conditions where there is a well-founded suspicion and cross-border implications for the integrity of financial markets or financial stability in the EU. In market abuse cases, ESMA will also be able to recommend the initiation of an investigation and information exchange among NCAs themselves and also with ESMA. Under the proposals, ESMA will have direct supervision of prospectuses for certain wholesale non-equity securities and asset-backed securities and prospectuses by specialist issuers, as well as prospectuses by third country issuers. The remaining majority of prospectuses will continue to be supervised by national competent authorities.

The one-stop shop for reporting capital markets data, and the establishment of a single point of entry to tap EU capital markets, for filing of prospectuses or authorisation of benchmark providers of EU label funds, without further notification requirements to different national authorities, will reduce the administrative burden for market participants and compliance costs through the harmonisation of standards and supervisory practices. The proposed reforms target the existing home bias among market participants, by further improving the level playing field of domestic and non-domestic firms operating across the single market.

ESMA can play a strong central role as a single point of contact on matters related to securities markets supervision vis-à-vis third country entities, ensuring that "financial entities with similar business size and risk profiles should be subject to the same standard of supervision regardless of where they are located in the EU and to avoid regulatory arbitrage".[34]

34 European Commission, "Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the Mid-term Review of the Capital Markets Union Action Plan", COM(2017) 292 final, p. 8.

3.1.2. The rationale based on arbitrage risks

Despite the more harmonised regulation of financial services and the more extensive and detailed regulatory outcomes post-crisis, there is still a risk of regulatory and supervisory arbitrage. The European Commission's proposal, promoted as a pragmatic solution facilitating consistency, coordination and cooperation of supervisory practices across the EU capital market, builds on the single rulebook. Recent EU documents[35] have also highlighted the need for uniform implementation of the harmonised EU regulatory framework. The main argument for a single pan-European authority supervising a broader range of capital market actors is that the existing state of affairs is unsatisfactory, given the inefficiency, inconsistency and lack of coordination of supervision carried out under the responsibility of NCAs.

Arbitrage risks have often been included in the reasoning behind strengthening and further integrating supervision of capital markets. The post-crisis enforcement and supervisory regime is not uniform across the EU, as regulatory expertise and resources vary greatly in the Member States and their capital markets are still very diverse subject to different national frameworks regarding, *inter alia*, diverging insolvency law, tax regimes and securities law. Particularly with regard to forum shopping and avoiding any risk of supervisory arbitrage, the European Commission's proposals grant ESMA a stronger role in coordinating some critical areas of supervision. In particular, the ESAs must be notified and asked for an opinion in specific cases when a financial institutional or market participant intends to significantly outsource, delegate or transfer risks to non-EU countries in a way that would allow it to benefit from the EU passport, while essentially carrying out its activities outside of the EU.

This creates risks for EU consumers and undermines trust in the market. Inadequate supervision in one Member State can be a source of risk for financial market participants and consumers in other Member States. Against this background, financial market operators have a strong incentive to look for the most advantageous and profitable enforcement and supervisory regime,

35 By way of indication, see European Parliament, Resolution 2015/2634(RSP) of 9 July 2015 on building a capital markets union (P8_TA(2015)0268); European Commission, "Report from the Commission to the European Parliament and Council on the operation of the ESAs and the ESFS", COM(2014) 509 final, 8 August 2014; European Parliament, Resolution A7/0 133/2014 of 9 March 2014 "on the European System of Financial Supervision Review" and "Review of the new European system of financial supervision. Part 1: The work of the European supervisory agencies", Study for the ECON Committee (IP/A/ECON/ST/2012–23), 23 October 2013.

given that the EU offers them the freedom to decide to locate their activities anywhere in the single market and provide their services based in any EU Member State.

The ultimate objective of centralised supervision is for investment firms and financial market participants not only to consistently apply the EU single rulebook for securities markets, but also to operate on a level playing field, under a strongly convergent supervisory culture across the EU single market. A single supervisor can address the legal certainty risks that arise under the current setup and management of EU capital market supervision through the network of home/host national competent authorities that leave room for interpretation and national discretions. On the one hand, service providers will find it easier and smoother to do business across borders in the EU's capital markets and will thus expand their product offerings and, on the other hand, users of financial products and services will benefit from a wider choice of passported products and services without concerns about consumer protection or market integrity.

3.2. Objections to a single capital markets supervisor

By way of indication, the ESMA's extended power's potential to achieve economies of scale has been called into question given the complexities entailed by EU-level supervision of the very broad spectrum of different capital market operators providing investment services or performing investment activities, and concurrently the need has been pointed out for differentiated supervision to match the diversity of capital market operators.[36] Strong doubts have been voiced about the practicality of supervisory centralisation, given the fact that EU capital markets are still fragmented for small and medium-sized firms.[37]

Another objection is that supervision over individual actors in the capital markets concerns the conduct of their day-to-day operations and therefore is dependent on close contacts between the supervisor and the supervised entities with regard to their transactions. It should be noted that in order to address such concerns, the European Commission's proposal limits the conferral on ESMA of new supervisory powers to specific sectors which are highly integrated or have important cross-border activities and which are,

36 See, by way of indication, Moloney, 2016: 399.

37 Avgouleas & Ferrarini, 2018: 56-57.

for the most part, governed by directly applicable EU legal acts: Regulation (EU) No 345/2013 on European venture capital funds (EuVECA), Regulation (EU) No 346/2013 on European social entrepreneurship funds (EuSEF), Regulation (EU) No 2015/760 on European long-term investment funds (ELTIF), Regulation (EU) No 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment, and Regulation (EU) No 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market. It is also indicative that the Commission took care to specify that it is "not proposing to change the responsibilities of national authorities to supervised areas such as central depositories, money market funds, trading venues, UCITS or alternative investment funds".[38]

It is finally worth reminding that up until recently prominent contributions to the scholarly debate around capital markets supervision and CMU argued that "shifts in the direction of a single capital markets supervisor would continue to take place slowly"[39] and that "the fiscal and constitutional difficulties which such EU centralisation of supervision would generate suggest[s] that these difficulties are unlikely to be addressed under the CMU agenda".[40]

4. POTENTIAL DRIVERS BEHIND THE PROPOSED SHIFT TOWARDS CENTRALISED SUPERVISION OF EU CAPITAL MARKETS

This section discusses potential endogenous and exogenous factors behind the European Commission's proposal for a reinforced supervisory regime of capital markets in the EU.

4.1. Some theoretical background

Through a 'feedback loop' mechanism, policy outcomes – i.e. decisions taken and rules adopted by the institutions – impact market operators, in turn, becoming policy inputs in the form of pressure on rule-makers to take legislative action or introduce institutional change.[41] Legislative initiatives are frequently

38 European Commission, Fact Sheet "Capital Markets Union: creating a stronger and more integrated European financial supervision", 20 September 2017, Point 3 "Key features of the proposal", p. 2.

39 Howell, 2017: 1027-1057.

40 Moloney, 2016: 415.

41 For more details on the feedback loop in the context of European integration, see Leuffen, Rittberger & Schimmelfennig, 2012 and also Diedrichs, Reiners & Wessels, 2010: 24, with regard to the operation of the feedback spiral of EU governance.

put forward in an effort to successfully resolve problems that arise in specific regulatory fields, as a result of policy inefficiencies or market failures, if a need is identified and a relevant policy demand for action is in some way formulated. A usual market failure that mobilises direct regulation arises from the externalities caused by the actions of economic actors in one jurisdiction on the welfare of the actors in another jurisdiction, which cannot be resolved through a process of jurisdictional competition. Given that each jurisdiction has an interest in protecting its citizens, the emergence of such externalities (caused e.g. by weak supervision and enforcement in some EU Member States) is a strong argument in favour of central regulatory intervention.

4.2. Exogenous factors

It should be noted that in the evolutionary path of the European Union, regulatory initiatives are often a reaction to external shocks.[42] An indicative example is the shock of the global financial crisis and subsequent euro area sovereign debt crisis which led to the massive regulatory reform package in the financial services sector.

4.2.1. The post-crisis environment

In a way, the European Commission's proposal to review the ESAs may be seen as a response to new challenges that have arisen in the field of supervision, *inter alia*, the non-uniform standards of supervision and enforcement of the single rulebook across the EU, partly as a result of the different stages of development and the quite diverse nature of capital markets in individual Member States, but also the stronger expertise of some competent authorities and the lack of efficiency of certain others. In the current juncture, there seems to be a potential to gather the political will on the part of Member States for more uniform supervision of capital markets, building on the extensive legislative framework (single rulebook), which would facilitate the creation of a single capital markets supervisor.

Furthermore, the political reality in the EU partly shaped by a more pro-European government in a core Member State such as France, pushing towards further European integration, might be another factor helping to create conducive conditions for a pan-European supervisory framework.

42 Lagaria, 2017: 20-21.

4.2.2. Brexit

The initial European Commission documents proposing the creation of a CMU in 2015 did not aim at the centralisation of supervision on a European level for all investment firms operating in the EU.[43] The European Commission's scheduled 2013-2014 formal review of the ESFS – prior to the establishment of the Single Supervisory Mechanism (SSM) – did not introduce any major changes to the ESAs/ESMA framework.[44] Despite the Five Presidents' Report[45] identifying a European single supervisor as a longer-term objective for EU capital markets, the Action Plan on the CMU,[46] presented by EU Commissioner Jonathan Hill in September 2015, did not reiterate this objective. As pointed out in a report of the House of Lords EU Select Committee, the UK had fiercely opposed centralised supervision, in an effort to avoid an impact on its financial market.[47]

In May 2017, following the submission on 29 March 2017 of the notification of the UK's intention to withdraw from the Union pursuant to Article 50 of the Treaty on European Union (TEU), the European Commission put forward the idea of centralised supervision in its Reflection Paper on the Deepening of the Economic and Monetary Union, pointing out that "the gradual strengthening of the supervisory framework should ultimately lead to a single European capital markets supervisor."[48] In its Mid-term Review of the Capital Markets Union Action Plan of June 2017, the European Commission referred both to the objectives stated in the above-mentioned Five Presidents' Report and the Reflection Paper on the Deepening of the EMU's focus on more centralised supervisory enforcement as a key for building the CMU, stressing

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43 European Commission, "Green Paper on Building a Capital Markets Union", COM(2015) 63 final, and European Council, "Resolution of 10 November 2015 on Capital Markets Union", Press Release 791/15.

44 European Commission, "Report from the Commission to the European Parliament and Council on the operation of the ESAs and ESFS", COM(2014) 509 final.

45 See "Completing Europe's Economic and Monetary Union – Report by Jean-Claude Juncker, in close cooperation with Donald Tusk, Jeroen Djisselbloem, Mario Draghi and Martin Schultz", 22 June 2015, Brussels: European Commission, also available at: https://www.ecb.europa.eu/pub/pdf/other/5presidentsreport.en.pdf.

46 European Commission, "Action plan on building a capital markets union", COM(2015) 468 final.

47 See House of Lords European Union Select Committee, "'Whatever it takes': the Five Presidents' Report on completing Economic and Monetary Union" – 13th Report of Session 2015-16, 12 May 2016, pp. 42-43, point (156).

48 European Commission, "Reflection Paper on the Deepening of the Economic and Monetary Union", 31 May 2017, COM(2017) 291 final, p. 20.

that "steps are underway to increase the ability of the ESAs to preserve EU orderly markets and financial stability".[49] The above Mid-term Review set out nine new priority actions including a revision of the European ESAs [in order to achieve] "more effective and consistent supervision by Q3 2017", explicitly stating that Brexit "strengthens the need for further integration of supervision at EU level".[50] In the ECB's contribution to the European Commission's consultation "Capital Markets Union Mid-term Review 2017", it is explicitly stipulated that: "The departure of the United Kingdom from the European Union will change the economic, institutional and political landscape in Europe. The imperative for building a true CMU is becoming even stronger, as the remaining Member States should have an increased interest in further developing and integrating capital markets within the EU-27." Furthermore, the proposal for a Regulation of the European Parliament and of the Council amending the ESAs Founding Regulations and provisions of sectoral legislative acts pertaining to the ESAs[51] also expressly mentions the decision of the United Kingdom to leave the EU pointing out that: "Brexit reinforces these challenges for supervisory arrangements within the remaining EU-27. The future departure of the EU's currently largest financial centre means that EU-27 capital markets need to develop further and supervisory arrangements must be strengthened to ensure that financial markets continue to support the economy on an adequate and sound basis."

It is true that Brexit has raised concerns in the financial sector given that the UK is currently Europe's major financial centre, *inter alia*, making up about

49 European Commission, "Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the Mid-term Review of the Capital Markets Union Action Plan", COM(2017) 292 final, p. 8.

50 Ibid.

51 European Commission, "Proposal for a Regulation of the European Parliament and of the Council, amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority); Regulation (EU) No 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority); Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority); Regulation (EU) No 345/2013 on European venture capital funds; Regulation (EU) No 346/2013 on European social entrepreneurship funds; Regulation (EU) No 600/2014 on markets in financial instruments; Regulation (EU) 2015/760 on European long-term investment funds; Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds; and Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market", COM(2017) 536 final, p. 2.

two thirds of EU equity trading.[52] According to the UK's Financial Conduct Authority (FCA), some 5,500 British registered companies use more than 330,000 passport licences to provide financial services across the EU.[53] When the UK becomes a third country, all EU primary and secondary law will cease to apply and free access to EU capital markets will cease. There is therefore a need to prepare stakeholders and adopt a common approach towards those firms that may seek to continue to benefit from access to EU financial markets through the relocation of their entities, activities and functions to one of the Member States of the EU-27.[54] In the post-Brexit era, there is a vital need for uniform standards of authorisation and ongoing supervision across the EU-27 in order to avoid 'beggar-thy-neighbour' policies. New authorisations must be granted in full compliance with EU law and in a coherent manner across the EU-27.

Another important issue concerns the practices of outsourcing and delegation of certain activities or functions outside the EU (e.g. to UK-based entities, including affiliates) from entities authorised in the EU. Any outsourcing or delegation arrangements from firms authorised in the EU to third country entities should be subject to a strict framework and consistently supervised. Both the ECB and ESMA, bearing in mind Brexit's potential impact on the stability and functioning of EU financial markets, have published FAQs[55] and general and sector-specific principles[56] in the context of more UK financial market participants seeking to relocate to the EU-27. These documents have been aimed at fostering consistency in authorisation, supervision and enfor-

52 See Speech on the State of European Financial Markets of ESMA Chair, Steven Maijoor, 17 October 2017, available at: https://www.esma.europa.eu/press-news/esma-news/steven-maijoor-state-european-financial-markets.

53 See "UK finance needs diplomacy to do without a passport", article by Paul J. Davies, *Wall Street Journal Europe*, 21 September 2016 and "Passporting is a two-way street", article by James Blitz, *Financial Times*, 21 September 2016.

54 Wymeersch (2018: 81-84) offers a detailed look into the post-Brexit conditions for UK financial institutions obtaining access to EU markets.

55 European Central Bank, "FAQs: Procedures for the relocation of banks to the euro area in the context of Brexit", last updated 11 January 2018, available on the ECB's website, at: https://www.bankingsupervision.europa.eu/banking/relocating/html/index.en.html.

56 See ESMA 35-43-762 "Opinion to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union", 31 May 2017, ESMA 35-45-344 "Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union", 13 July 2017, ESMA 70-154-270 "Opinion to support supervisory convergence in the area of secondary markets in the context of the United Kingdom withdrawing from the European Union", 13 July 2017, and ESMA 42-110-433 "General Principles to support supervisory convergence in the context of the UK withdrawing from the EU", 13 July 2017.

cement related to such relocation. In light of the above, there seems to be reinforced expediency for consistent supervision across the EU.

4.3. Endogenous factors

The latest institutional reform proposal can concurrently be explained by institutional and intergovernmental forces, *inter alia*, Member State preferences, the European Commission's institutional self-interest and ESMA's policy entrepreneurship as an administrative actor.

4.3.1. Member State preferences

Member State preferences are a key determinative influence on regulatory interventions at EU level. Member States have the final say in the elaboration of the rules governing economic activities in their jurisdictions.[57] These preferences are often shaped by existing (traditional) structures or determined by an effort to maximise benefits from the new rules vis-à-vis other jurisdictions. In this regard, Member State political motivations and subsequent influence on the evolution of the institutional design of the EU capital market has been decisive. This apart, the new intergovernmental balance of power in the Council, as a result of the declining influence of the previously strong UK pole (as the EU's largest financial centre) in the aftermath of the Brexit vote, has been a significant factor favouring the latest centralising initiative in the field of financial supervision.

4.3.2. The European Commission

The European Commission has significant incentives to protect its institutional prerogatives following the establishment of a Banking Union encompassing a powerful European body responsible for centralised supervision of systemically important credit institutions in countries participating in the Banking Union, the Single Supervisory Mechanism (SSM), situated within another EU institution, the ECB.[58] In the securities field, assigning supervision powers over capital market actors to the ECB, making use of existing Treaty provisions, i.e. Article 127(6) TFEU, was not put forward as an option. In what may be seen as an incremental approach, the latest proposals aim at centralising supervision by expanding the scope of ESMA's direct supervisory powers over more types of entities, given ESMA's strong technocratic credentials and independence guarantee (see also following section).

57 Drezner, 2005: 843.

58 For a detailed study of the SSM, see Gortsos, 2015.

4.3.3. ESMA

Having built a strong track record in the elaboration of an extensive and detailed volume of technical rules for financial market operators, ESMA is now entering an era of ensuring consistent understanding and application of the single rulebook in EU capital markets. As the massive pressure and heavy burden of the post-crisis financial regulatory reform has subsided, a shift in the strategic orientation of ESMA was to be expected. ESMA's "Strategic Orientation 2016-2020"[59] marks a stronger emphasis on its supervisory tasks.

Another driver behind centralised supervision that should not be overlooked is the dynamic relationship between the European Commission as an EU institution with rule-making power and ESMA as an EU agency subject to the constitutional limits of the EU Treaties and assigned with special competences in a specific sector. Under its current mandate, its expressly defined sanctioning powers in certain circumstances on CRAs and TRs are subject to very detailed and restrictive conditions (see sections 2.2.1-2.2.2) set out in relevant sectoral legislative acts. In this respect, the European Commission has significant incentives to protect its institutional primacy and accordingly promote a form of centralised supervision that would necessitate its mediating role as a solution bypassing the legal basis problem for a single supervisor at EU level (and not requiring Treaty change).

5. CONCLUDING REMARKS

This paper's analysis has outlined some exogenous and endogenous factors that might have potentially contributed to the shift towards centralised supervision of capital markets in the EU as part of the CMU agenda. On the one hand, certain external factors may be regarded as potentially having influenced the centralising initiative of the European Commission in the new post-crisis environment, particularly given the rationale of arbitrage risks. On the other hand, the European Commission's proposal for a single capital markets supervisor may be seen as another step in an incremental policy process, to the extent that it builds on the dynamics of capital market supervision, which currently leaves day-to-day supervision to the national level with only a few exceptions, and addresses the weaknesses of the existing state of affairs.

59 ESMA Strategic Orientation 2016-2020, 15 June 2015, ESMA/2015/935, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-935_esma_strategic_orientation_2016-2020.pdf.

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