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# Submission by the City of London Law Society Company Law Committee to the Treasury Committee inquiry into proposals for European Macro and Microprudential Financial Regulation

The City of London Law Society (CLLS) represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the Treasury Committee inquiry into proposals for European Macro and Microprudential Financial Regulation has been prepared by the CLLS Company Law Committee.

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## 1. Summary

- This submission is concerned solely with the proposal to include within the remit of the European Securities and Markets Authority (ESMA) the Community legislation that deals with companies, the holders of securities issued by them and their directors (and other senior managers). This includes:
  - the rules relating to listing of securities;
  - rules relating to prospectuses;
  - disclosure obligations of listed companies, both periodic and ad hoc;

- obligations of shareholders to disclose their interests;

- the regulation of takeovers under the City Code on Takeovers and Mergers;

- the rules relating to market abuse.

- The new European architecture for Financial Regulation is being brought forward as a response to the "real and serious risks to the stability of the internal market" created by the financial and economic crisis[1]. The areas of regulation with which we are concerned ("**securities regulation**") are not in any way implicated in the financial crisis and there is no suggestion in any of the Commission publications on the proposals that they are. No attempt has been made to articulate a proper justification for the imposition of a new layer of regulatory responsibility for these areas, an approach which will inevitably undermine the authority of the national regulators (in the UK, the FSA and the Takeover Panel).

- The main thrust of the proposals is to establish a closely harmonised system of **financial regulation**[2] which covers the supervision of financial institutions and markets, including prudential supervision of financial institutions and the "**conduct of business regulation**" of financial institutions. We offer no comment on that. We are, however, very concerned that the proposals would result in a major change in the approach to securities regulation without any analysis of the need for that change or its likely consequences. We believe that conferring on ESMA, as a European "super-regulator", the role of rulemaker, with powers of direct intervention, would represent a significant change in the framework of securities regulation that may threaten the established working of the capital markets in the UK.

- In the area of securities regulation, the legislation has adopted different approaches according to the objectives of the specific legislation, complying with the principle of subsidiarity. This has allowed flexibility where appropriate for the rules to respond to local market dynamics. Although the proposals do not indicate that there would be an immediate major change in the framework for securities regulation, adopting a common approach to both financial regulation (with its core aspiration of a "single rule book") and securities regulation, will shift the geography significantly towards greater harmonisation with an inevitable effect over time on securities regulation. There may be a case to be made for greater harmonisation in areas of securities regulation but no attempt has been made to present that case.

[1] Paragraph 4 of the Explanatory Memorandum.

[2] In its response to the House of Lords EU Committee Report "The future of EU financial regulation and supervision", the European Commission explained that the proposal of the European System of Financial Supervisors (ESFS), which includes ESMA, was "the supervision of individual financial institutions", with no mention of the wider regulatory issues with which we are concerned (C(2009)8014, 26 October 2009).

We suggest therefore that if the proposals as a whole are adopted, ESMA's role in the areas we have identified should be confined to the role CESR currently performs. If thought appropriate, there could be a subsequent consultation and debate of the merits of an expansion of ESMA's role of these areas of regulation.

- The systemic problems recently experienced are not a result of failures in the system of securities regulation and there is no justification for proceeding with this step change to increased harmonisation with the same urgency that may be required in relation to financial regulation. Any such change should be the subject of proper consideration and full consultation with all stakeholders. The fact that there has been some prior consultation on the wider de Larosière and Commission proposals has not helped: those proposals focus on significant financial market issues, which of course have been the focus of responses. Given the excellent consultation processes which led to the current regime, it would be highly regrettable to introduce an entirely new framework on the back of unrelated concerns about banks and financial institutions.

- If, contrary to our views, securities regulation is brought within the scope of the new architecture, proper consideration must be given to the essential differences between the regulation of individual regulated entities (which is what financial regulation involves) and regulation that provides a framework for numbers of unregulated entities and individuals to interact (which is what securities regulation deals with).

A simplistic "one size fits all" approach will not be appropriate. In particular the powers of direct intervention (Article 9) and to impose emergency measures (Article 10), should be limited to areas of financial regulation.

- The proposed inclusion of takeovers regulation within the scope of ESMA's powers requires particular attention. The Takeovers Directive was the result of many years discussion and negotiation and its minimum harmonisation approach reflected a recognition of the very considerable differences between Member States in their regulation of takeovers. For the UK, it was very important that the Takeovers Directive did not interfere in the smooth operation of the well established and well respected system operated by the City Panel on Takeovers and Mergers. That objective was largely achieved. CESR's only role in relation to takeovers regulation is to provide an informal framework for relevant national regulators to exchange views and information. No justification has been advanced for bringing takeover regulation within the remit of ESMA and in our view it should not be.

We see no benefit, and considerable risks, if this important area of regulation is brought within the scope of ESMA's authority.

## 2. Scope of our concerns

We are concerned solely with the proposals as they relate to the European Securities and Markets Authority (ESMA). ESMA is to be given responsibility for a wide range of areas of regulation. These include "**financial regulation**":

- regulations governing the operation and functioning of financial markets;
- regulation of the activities of credit institutions, insurance undertakings and investment firms and, prospectively, alternative investment fund managers and credit rating agencies (which we refer to as "**financial institutions**").

In addition, ESMA would have responsibility for "**securities regulation**", including:

- regulation of market abuse[3];
- obligations of issuers of securities to make disclosures, both ad hoc[4] and on a regular basis[5];
- obligations of holders of shares to make disclosures regarding their interests[6];
- requirements for publication of prospectuses[7];
- requirements for admission to listing[8];
- regulation of takeovers[9].

## 3. Background - the case for change

3.1 The origin of the current proposal lies in the Report of the High Level Group on Financial Supervision in the EU chaired by Jacques de Larosière. That Group's terms of reference were:

> "The Group is therefore requested to make proposals to strengthen European supervisory arrangements covering all financial sectors, with the objective to establish a more efficient, integrated and sustainable European system of supervision.
>
> In particular the Group should consider:

[3] Market Abuse Directive (other than Article 6).
[4] Article 6 of the Market Abuse Directive.
[5] Transparency Directive.
[6] Transparency Directive.
[7] Prospectus Directive.
[8] Consolidated Admissions and Reporting Directive.
[9] Takeovers Directive.

- how *the supervision of European financial institutions and markets* should best be organised to ensure the prudential soundness of institutions, the orderly functioning of markets and thereby the protection of depositors, policy-holders and investors;

- how *to strengthen European cooperation on financial stability oversight*, early warning mechanisms and crisis management, including the management of cross border and cross sectoral risks;

- how supervisors in the EU's competent authorities should cooperate with other major jurisdictions to help *safeguard financial stability* at the global level." (emphasis added)

In line with these terms of reference, the Report[10] discussed only the prudential supervision of financial institutions and some other aspects of financial regulation. It contained no explanation of why securities regulation should be brought within the architecture it proposed.

3.2 The Commission Communication in May 2009[11] describes the case for macro and **micro-prudential reform**. Its focus was on financial regulation, not on securities regulation, and it did not set out any justification for the changes it proposed in relation to securities regulation. For example:

> "The focal point for day to day supervision would remain at the national level, with national supervisors remaining responsible for the supervision of individual entities, for example with respect to capital adequacy."

and

> "…the European Supervisory Authorities could also be empowered to adopt decisions directly applicable to financial institutions in relation to requirements stemming from EU Regulations relating to the prudential supervision of financial institutions and markets as well as the stability of the financial system."

3.3 The language used in the Commission Communication is in terms of "supervision"[12] and seems to be focussed on the regulation of financial institutions and not on the wider regulation of financial markets and their participants. The approach up to now in relation to securities regulation has been to allow national authorities to operate their national rules that implement the Community legislation, an approach that reflects the continuing diversity of financial markets that each operate under different structural

[10] Report of the High Level Group on Financial Supervision in the EU (Brussels, 25 February 2009).
[11] COM(2009)252 final 27th May 2009.
[12] E.g. "The focal point for day to day supervision would remain at national level" (Communication, paragraph 4). "The European Supervisory Authorities should … contribute to the emergence of a common supervisory culture and consistent supervisory practices" (ibid).

conditions. Over time there may be movement towards fully harmonised markets but we do not believe a step-change in approach is appropriate, or that adequate (or any) justification for that change has been advanced.

3.4 As there has been no attempt to justify the inclusion of securities regulation within the architecture (other than by sweeping comments about the benefits of harmonisation), there has been no attempt to justify the need for urgency in doing so. As there is no need to move quickly in the area of securities regulation, we strongly urge caution and suggest that time be taken to allow a proper debate. It would be possible to achieve this, without impeding the establishment of the architecture, by proceeding with the establishment of ESMA and conferring on it in relation to securities regulation the roles and responsibilities currently performed by CESR.

Implementation without broader and substantive consultation (and greater justification being given) will fail to meet the Commission's "Better Regulation" objectives.

## 4. Effect of the proposals

4.1 The principal powers of the ESMA that are relevant (and which we think are unnecessary in relation to securities regulation) are:

- the power to impose technical standards (Article 7);
- the power to issue guidelines and recommendations (Article 8);
- the direct intervention power (Article 9);
- the power to require action in emergencies (Article 10).

### 4.2 Technical standards

The power for ESMA to impose technical standards under Article 7 applies in relation to "the areas specifically set out in the legislation referred to in Article 1(2)" (Paragraph 1). The scope of this is unclear in the proposed Regulation. Neither Recital 14 nor paragraph 6.2.1 of the Explanatory Memorandum shed much light on what is intended. Paragraph 6.2.1 refers to "an effective instrument to strengthen Level 3 of the Lamfalussy structure" but refers to "areas specified" in the principal legislation. Recital 14 refers to "areas defined by Community Law". Paragraph 6.2.1 refers to "issues of a highly technical nature" while Recital 14 refers to "technical standards, which do not involve policy choices". However, it appears from the Commission Staff Working Document[13] that the intention is to include areas already identified in the primary legislation as having scope for Lamfalussy Level 2 implementation and other areas identified in the Working Document and which are now set out in the proposed Amending Directive[14]. In relation to

[13] SEC(2009)1233.
[14] 2009/0161(COD).

securities regulation these relate to only a few matters[15]. If the intention is that the technical standards should only relate to issues of a highly technical nature, the Regulation should make that clear.

4.3 If the conclusion in paragraph 4.2 is correct, areas that may be covered by technical standards would include:

(i) MAD:

- the definition of "inside information";
- the requirement for disclosure of information and for delaying disclosure.

(ii) Transparency Directive:

- details relating to the notification of interests in shares.

(iii) Prospectus Directive:

- exemptions from the obligation to publish a prospectus in connection with a takeover or merger;
- the information to be included in a prospectus.

(iv) Takeovers Directive

- (possibly) the requirements for the information to be included in an offer document[16].

The Appendix contains a complete list of the areas where implementing measures are contemplated and where, therefore, technical measures may be adopted.

4.4 The Commission's publications in connection with the proposal contain a number of references to a "single rulebook" (see, for example, paragraph 4 of the Explanatory Memorandum[17]) but we do not see how that ties in with the proposed Regulation. We assume that the "single rulebook" is an objective confined to financial regulation, as we assume it is to be achieved through adoption of technical standards under Article 7 and there is no framework for the adoption of a single rulebook in relation to securities regulation. We think it important that it should be made clear that the single rulebook is not an objective in relation to securities regulation.

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[15] See the Appendix, where the additional areas for technical standards are identified.

[16] It is not clear that the possibility of rules being adopted for the application of Takeovers Directive, Article 6(3) can be brought within the procedure for adopting technical standards in Article 7. Under Article 6(4) of the Takeovers Directive, the adoption of such rules is required to follow the procedure as set out in Article 18.

[17] See also the Commission Communication (COM(2009)252) paragraph 4.2, which refers to "a single set of harmonised rules".

### 4.5 Guidelines and recommendations

Article 8 would confer on ESMA the power to adopt guidelines and recommendations. This is similar to the role currently performed by CESR but is strengthened by the requirement that competent authorities "make every effort to comply with those guidelines and recommendations". If a competent authority does not apply ESMA's guidelines or recommendations it must notify ESMA and give reasons. There is a significant risk that giving ESMA's guidelines and recommendations this additional authority will be counter-productive, as the process for formulating and adopting binding guidelines and recommendations will inevitably become more cumbersome and will take longer. In the context of securities regulation, CESR's non-binding guidance has been effective in promoting more consistent practical application of the regulations and we do not see any case for change.

If Article 8 powers are retained in relation to securities regulation, we would be concerned that there is no mention in the existing draft of any requirement for public consultation (in contrast to the position in relation to technical standards[18]). If authoritative guidelines are to be provided by ESMA, it is essential that a proper consultation process is undertaken.

### 4.6 Direct intervention

Article 9 would confer on ESMA powers to intervene directly in the way Community laws are applied by national regulators. It contemplates a three stage process:

(i) first, (having investigated) ESMA may address a recommendation setting out action required to comply with Community law;

(ii) second, a Commission decision requiring the competent authority to take action to comply with Community law; and

(iii) subject to two important conditions, ESMA may adopt a decision addressed to a financial market participant. The conditions are:

  (a) a remedy "in a timely manner" must be necessary to "maintain or restore neutral conditions of competition in the market or ensure the orderly functioning and integrity of the financial system"; and

  (b) the non-compliance must be in respect of Community Laws that are directly applicable to financial market participants.

This process is potentially time-consuming (the Commission has three months and may take an additional month to take any Decision required of it at the second Stage). It appears that decisions addressed to financial market participants must relate to Community laws that are "directly applicable" by

[18] Article 7(2).

virtue of being set out in Regulations (see Recital 20). However, there is academic debate whether other Community legislation (e.g. Directives) may in some circumstances be directly applicable. Given the importance to financial market participants of knowing what authority an ESMA decision would have, the Article should refer specifically to "Regulations".

4.7 With the broad scope proposed, this process is objectionable as a matter of principle. It disturbs the existing balance between Community institutions and Member States and their national agencies. The primary determination of a failure to comply with Community Law will not be a judicial determination by the Court of Justice but will be an executive decision of the Commission[19].

4.8 Article 9(1) provides:

> "Where a competent authority has not correctly applied the legislation referred to in Article 1(2), …. the Authority shall have the power set out in paragraphs 2, 3 and 6 of this Article."

The legislation referred to includes Directives, Regulations and Decisions. In its reference to Directives the Article must be regarded as legally flawed. It is for Member States to implement Directives and competent authorities do not "apply" Directives, they apply the laws adopted by Member States to implement them. We question whether the Commission can, by Regulation, take power to intervene directly in this way in Member State's decisions as to implementation of Community Law. It seems from the sub-clause omitted from the quotation above ("in particular by failing to ensure that a financial market participant satisfies the requirements laid down in that legislation") that the intention was to limit the scope to the enforcement of rules for financial regulation (presumably the single rulebook for financial institutions). If that is so, the Article should be amended accordingly.

4.9 Even if limited to the "enforcement" of directly applicable provisions (including technical standards adopted under Article 7) the process set out in Article 9 raises some significant legal issues, by making determination of the legality of decisions of competent authorities a matter of executive decision and not judicial determination. A person subject to a relevant provision will face an unacceptable level of uncertainty as to its legal obligations in the event of a disagreement between the relevant competent authority and ESMA (and the Commission). The Commission may require the competent authority to adopt a position with which the competent authority disagrees while the person concerned seeks redress against the competent authority concerned in its national courts.

**4.10 Emergency measures**

Article 10 provides a procedure for the adoption of measures in emergency situations:

[19] Art 226 EC requires that the Commission's "reasoned opinion" of non-compliance be brought to the Court.

(i) it is for the Commission to determine that an "emergency situation" has arisen;

(ii) ESMA may then adopt individual decisions addressed to competent authorities to take action; the action required must be "in accordance with the legislation referred to in Article 1(2)" and must have as its object addressing risks:

(a) that may jeopardise the orderly functioning and integrity of financial markets; or

(b) the stability of the whole or part of the financial system,

and must do so "by ensuring that financial market participants and competent authorities satisfy the requirements laid down in [the legislation referred to in Article 1(2)]";

(iii) if a competent authority does not comply with the decision and the decision relates to a requirement that is directly applicable, ESMA may adopt a decision addressed directly to a financial market participant. We note, therefore, that ESMA cannot compel the competent authority to act[20].

4.11 We do not see how Article 10 emergency measures could be applied in relation to securities regulation. We suggest therefore that the scope of the actions that might be required under Article 10 should be specified more clearly and should not include areas of securities regulation.[21]

9 November 2009



[20] It would be ultra vires if the Regulation purported to provide such a power. This is recognised by the express reference to the powers of the Commission under Article 226 EC Treaty.

[21] It is suggested in the Impact Assessment (paragaph 6.1.1.5) that this power could have been used to impose an EEA-wide short-selling ban but we do not believe that would be possible without additional primary legislation (see paragraph 60 of the CESR Consultation Paper on its Proposal for a Pan-European Short Selling Disclosure Regime CESR/09-581, July 2009) which would have to be in a form that was directly applicable for it to be within the scope of Article 10.

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## APPENDIX

*Note: (1) The actions in italics have already been the subject of EC implementing measures.*

*(2) The sections in bold are expressly referred to in the proposed Directive which would amend MAD, the Transparency Directive and the Prospectus Directive and give ESMA express authority to make draft technical standards in these areas.*

The technical standards may relate to:

(i) MAD

- The definitions of *inside information, market manipulation* and financial instruments (Article 1(1), 1(2), and 1(3));
- *The requirements for disclosure of inside information (Article 6(1)* and 6(3));
- *The requirements for delaying disclosure of inside information (Article 6(2));*
- The requirements for informing a competent authority of a decision to delay disclosure (Article 6(2));
- *The conditions under which issuers must draw up an insider list and the conditions under which they must be updated* (Article 6(3));
- *The categories of person who are subject to a duty of disclosure as persons discharging managerial responsibilities or those closely associated with them, and the triggers for their disclosure requirements (Article 6(4));*
- *The notification requirements of professional persons arranging a financial transaction who suspect insider dealing or market manipulation* (Article 6(9));
- **The procedures for exchange of information between competent authorities and for cross border inspections (Article 16(5))[22].**

(ii) Transparency Directive

- The definitions in Article 2(1), and *in particular procedural arrangements by which an issuer may choose its home Member State under Article 2(1)(i)(ii);*

[22] The sections in bold are expressly referred to in the proposed Directive which would amend MAD, the Transparency Directive and the Prospectus Directive and give ESMA express authority to make draft technical standards in these areas.

- An indicative list of means which are not be considered as electronic means (Article 2(1)(l);

- The requirements for publication of the annual financial report, in particular the conditions under which it is to remain available to the public (Article 4(1));

- The *requirements for publication of the half yearly financial report*, in particular the conditions under which it is to remain available to the public, the auditor's review, *and the minimum content of a condensed balance sheet which is not prepared in accordance with international accounting standards (Article 5(1)-(5));*

- The requirements for the notification of the acquisition or disposal of major shareholdings *and the market maker exemption, in particular the length of the "short settlement cycle"* (Article 9(2), 9(4), 9(5));

- The *procedures for the notification of the acquisition or disposal of a major shareholding, including the management company and investment firm exemptions*, and **in particular the adoption of a standard form when notifying the issuer or when the issuer files with the competent authority** *and relevant timings* (Article 12(1), 12(2), 12(4), 12(5), 12(6), a new **12(9)**);

- *The types of financial instruments and agreements which will apply rise to calculating a major shareholding notification*, the contents of the notification, the notification period and the recipient of the notification (Article 13(1)). **A new article 13(3) proposes a standard form when notifying to the issuer under article 13(1) and when issuers file with the competent authority.**

- The notification requirements when a company purchases its own shares (Article 14(1));

- The procedures for making information available to shareholders for issuers whose shares are admitted to trading on a regulated market (Article 17(1)-(3));

- The procedures for making information available to debt holders for issuers whose debt securities are admitted to trading on a regulated market (Article 18(1)-(4));

- The procedures for issuers filing regulated information with the competent authority, in particular with regard to filing by electronic means (Article 19(1)-(3)).

- *The standards for the manner of disseminating regulated information*, and in particular for the central storage mechanism (Article 21(1)-(3));

- *The information requirements for issuers whose registered office is in a third country, in particular ensuring the equivalence of information (Article 23(1), 23(2), 23(6)).*

(iii) Prospectus Directive

- The definitions in Article 2(1);
- The exemption from the obligation to publish a prospectus for securities offered, or admitted to trading, in connection with a takeover or merger, in particular the requirement of "equivalence" in the takeover document (Article 4(1)(b) – (c) and 4(2)(c) – (d));
- *The format of the prospectus or base prospectus and supplements (Article 5);*
- *The specific information to be included in a prospectus (Article 7);*
- **The conditions for the authorised omission of information from a prospectus (Article 8(2));**
- *The method of disclosure of a document referring to all information that an issuer has published over the preceding year in accordance with securities regulations (Article 10(1));*
- *The requirements for incorporating information into a prospectus by reference (Article 11(3));*
- The time limits for approval of the prospectus (Article 13);
- *The manner of making the prospectus public (Article 14(1) – (4));*
- *The dissemination of advertisements announcing an intention to offer securities to the public or their admission to trading on a regulated market (Article 15);*
- The requirements for a third country to ensure the equivalence of prospectuses by reason of its national law or international standards (Article 20).

**It is also proposed in the draft Directive to authorise ESMA to make technical standards:**

- **to determine the conditions of the obligation to provide a supplement to the prospectus under a new article 16(3);**
- **to determine the conditions relating to the procedures for the notification to ESMA of the certificate of approval, the copy of the prospectus, the**

**translation of the summary and any supplement to the prospectus under a new article 18(4);**

- **to determine the conditions of cooperation and exchange of information between competent authorities, including the development of standard forms or templates for such cooperation and exchange of information under a new article 22(4).**