

## THE LAMFALUSSY PROCESS: DOES IT WORK AND WHAT ARE THE CONSEQUENCES OF EXTENSION?

### Summary

#### Does Lamfalussy Work in Financial Markets?

- The experience with the Lamfalussy process to date is limited, but generally positive. Evaluation of early lessons – especially by the Inter-Institutional Monitoring Group (IIMG) – can and should play an essential role in improving future implementation.
- A key challenge for the Lamfalussy process so far has been the tight FSAP timetable. The ultimate success of the Lamfalussy reform will depend not on the quantity of legislation delivered in the available time, but rather the quality.
- Prior consultation is vital to the quality and acceptance of any Level 1 proposal, and will also help to draw a clear distinction between Level 1 and Level 2 rules. Political discussions held at Level 1 are still not adequately transparent and undermine any transparency achieved through prior consultation.
- Level 2 also involves policy decisions, which need to become more transparent. Useful steps would include a more explicit formulation of policy tradeoffs and options by CESR, an explanation of the Commission's reasoning behind the draft legal measures, and greater transparency in the role played by the ESC.
- Consultation by CESR will be most effective if sufficient time is allowed, if the participants can review the package in its entirety, and if appropriate details are left to Level 3. The work on the ISD presents important challenges in this regard.
- In Market Abuse and Prospectus Directives, it has proven difficult to avoid excessive detail at Level 2, and very few issues have been left to Level 3. The ISD should be a good opportunity to improve on this point, but the Directive under discussion is not yet sufficiently focused on the core principles.

#### Extension of the Lamfalussy Process and Next Steps:

- Financial industry bodies have supported extension of the Lamfalussy process to banking and insurance, notably on grounds of a transparent and structured consultation process.
- The Commission's legislative package for setting up the new committees is welcome but there is concern that it has come too late in the day for it to be adopted before the end of the parliamentary term in April 2004.

### **1. Does Lamfalussy Work in Financial Markets?**

Based on the experience of the first three Directive proposals using the Lamfalussy process (Market Abuse, Prospectuses and Investment Services) the assessment can be cautiously positive. Despite some early glitches, the process promises to bring increased coherence of Level 1 legislation, greater flexibility in adopting technical rules, greater involvement of all interested parties, and (perhaps) speed to the EU financial markets regulatory process.

#### ***Background***

The new legislative techniques proposed in the Lamfalussy Report of 2001 were not only aimed at speed, but at quality, flexibility, coherence/consistency, involvement of expertise, transparency and efficiency. To achieve these goals, the Wise Men suggested separating "principle" from "detail" in the regulatory decisions, minimising room for ambiguity in primary

legislation and allowing technical rules to flow organically from the underlying principles. Public consultation with all interested parties was to be the guarantee of the quality and proportionality of each of level of rule-setting. Finally, the reform targeted greater coordination and trust among regulators implementing the rules and better enforcement of the rules once adopted.

With these objectives in mind, the framework proposed a four-level approach:

- Level 1 – Primary legislation to define broad "framework" principles
- Level 2 - Technical implementing measures to be adopted by the Commission with the assistance of a regulatory committee and an advisory committee
- Level 3 – Cooperation among national regulators to ensure consistent interpretation of Level 2 rules
- Level 4 – Enforcement to ensure consistent implementation of EU legislation.

Inter-institutional agreement on this process was eventually reached (following the Commission's commitment to safeguard the Parliament's role, a principle fully supported by the industry) and an Inter-Institutional Monitoring Group (IIMG), composed of 6 people proposed by the three institutions was set up. The first full report – drafted after extensive consultation with market participants – is due mid-December 2003.

The first three proposals utilizing the Lamfalussy process are in varying stages of progress:

- **Market Abuse Directive** - The first batch of Level 2 implementing measures was adopted by the Commission on 29 October 2003. The draft of the second batch was published by the Commission for comment on 10 November and will be submitted for formal review by the ESC (and the Parliament) in December.
- **Prospectus Directive** – On 12 November 2003, the Commission issued for public review the first draft implementing measures for all the issues on which CESR has completed its advice. (Remaining issues will be finalized by CESR by the end of the year).
- **Investment Services Directive (ISD)** – The Directive approaches Second Reading in the EP and in the Council. Substantial differences between the views of the EP and of Member States make it unclear, however, how soon CESR can start its technical work on a provisional basis.

### *Assessment to Date: Despite Early Challenges, Firmly on Track*

#### **Quality versus Speed**

A key challenge for the Lamfalussy process so far has been the tight FSAP timetable (deadlines of end-2003 for the integration of EU securities markets and 2005 for the rest of the plan). Although it is understandably important to keep up the momentum and respect the deadlines, the success of the Lamfalussy process will be judged not by the *quantity* it delivers in the timeframe available, but rather by the *quality*, defined overall by the effectiveness, flexibility, proportionality, transparency and coherence of the final legislation at all levels of the regulatory structure.

Quality of the product is also determined by the quality of consultation. Good consultation is not just a question of sending out draft proposals to interested parties; it also needs to include sufficient time for responses to be prepared by the consulted stakeholders and taken into account by the policymakers. This may require an interactive process of several rounds of discussion.

The Commission has steadily improved its consultations along these lines. They ought to continue their efforts in this direction.

A further key element determining the quality of legislation is the attention given to the cost-effectiveness and proportionality of legislation, a point that was explicitly raised in the ECON discussion of IIMG's interim report. Proportionality should take into the need to protect the global competitiveness of European markets while generating concrete net benefits for investors and the economy as a whole.

### **Transparency at Level 1**

Until the final stages of Commission adoption, when last minute changes were made, the public consultation followed for the ISD was exemplary. This stood in stark contrast with the evident lack of consultation in the preparation of the texts of the Market Abuse and Prospectus Directives. Although views vary on the merits of the last-minute changes in the ISD text, there is wide recognition by all market participants that dealing with important issues in this way is not in accord with the spirit of open consultation. There is expectation that future EU legislation in financial markets will follow the ISD as a model for prior consultation.

Political discussions held at Level 1 *after* the adoption of a proposal – especially at the Council – have just as much an impact on transparency as prior consultation. On this criterion, the Parliament provides a high level of transparency of its deliberations on proposed legislation. For the Lamfalussy process to achieve the needed level of transparency at Level 1, it is important for the Council also to adopt equivalent working principles.

### **Transparency of the Policy Decisions at Level 2**

The first Lamfalussy implementing measures (Market Abuse adopted in October 2003) demonstrate that Level 2 – although a technical level – also involves policy decisions. To ensure that these choices are within the scope of the mandate, the mandate itself should be very clear. Furthermore, there must be adequate transparency of the policy decisions made at Level 2.

The Commission's decision to publish drafts of the implementing measures is a first and very welcome step in this process. The financial industry has supported the opportunity to address the Commission directly on the proposed legal text in particular because the translation into legal language can lead to problems of interpretation and the legal measures may go beyond the scope of the technical advice provided by CESR.

The process can still be improved further. CESR so far tends not to present policy options (or related tradeoffs) when submitting its advice to the Commission. Neither does it include in its advice adequate feedback on the practical problems brought to its attention during its own consultation. It would also be useful for the Commission to issue a feedback statement when drafting its draft measures, outlining the basis of its choices, especially when they deviate from the results of consultation.

Finally, in both its advisory and regulatory roles, the ESC has some way to go before becoming sufficiently transparent. The Commission has made a laudable effort on this point by publishing the agendas and minutes of ESC meetings and revised versions of draft measures on its website.

### **Consultation by CESR**

It is a good sign that CESR has adopted a charter and a public statement on principles of consultation. To a large extent, the main defect in consultation by CESR so far is the lack of

time, which should cease to be a problem when the current pressure of timetables is over. CESR has stated that it needs at least nine to 12 months for any implementing measure if it is to conduct a proper consultation.

Another aspect of CESR's consultation is the use of provisional mandates. There is broad agreement that a provisional mandate, if it cannot be avoided, must take all developments at Level 1 into account and must be structured so as not to prejudice the outcome of the Council and Parliament deliberations. It may be necessary to concentrate the early provisional mandate(s) on the subjects on which the Parliament and Council views converge.

A related aspect of CESR's work (and overall Level 2 preparation) is the use of staggered schedules, i.e. splitting of the Level 2 work. While it may be an efficient use of time and resources in certain cases, its main drawback is not allowing one to assess the technical advice in its entirety, which is crucial for inter-linked subjects. In this context, it is to be welcomed that, in certain cases, CESR modified its earlier advice after the latter consultation. Again, this technique, dictated by the current time pressure, may no longer be necessary in the post-FSAP period.

### **Getting the Degree of Detail Right at Each Level**

In the Market Abuse and Prospectus Directives, it has proven difficult to avoid excessive detail at Level 2, and few issues have been left to Level 3. The line between the framework principles and the implementing measures in these cases was not well-defined and the starting point of Level 1 was more detailed than called for by the Lamfalussy process. As noted by the IIMG, one could also observe a tendency to "amalgamate" existing rules at Level 2. This tendency should fade in time with stronger cooperation between regulators, greater convergence of rules, and better enforcement.

The financial industry has urged that the issue of detail for Levels 2 and 3 be resolved. The ISD should provide a good opportunity to improve on this point, but to make it happen, the Directive under discussion will have to become more focused on the core principles.

### **Choice of Instruments at Level 2**

So far, the Commission has proposed two "Commission Regulations" (safe harbours for Market Abuse and the entire package for Prospectus) and three "Commission Directives" (for the rest of Market Abuse measures). The Lamfalussy process does not establish a preference for one legislative instrument over the other. What matters in this choice is how to best avoid causing unnecessary delays in implementation or divergences in interpretation. From this perspective, there is some concern that the use of different legislative instruments at Level 1 and Level 2 could lead to problems of implementation. More generally, speed does not follow directly from "Regulations" at Level 2 and Directives do not necessarily mean delays.

### **Implementation and Enforcement**

The question of implementation and enforcement has not yet been addressed (although it has received attention in the Commission's latest Internal Market Strategy). Towards the end of 2004, all EU countries will be at the implementation stage of the first major FSAP proposals. In order to ensure that the Lamfalussy process achieves the envisaged results, the Commission needs to begin to develop proposals to assist consistent implementation and overcome obstacles to cross-border business on the ground. The industry expects to be fully involved in this endeavour. As highlighted both by the Committee of Wise Men's and the IIMG, regulatory understaffing and capacity problems will also have to be addressed to achieve consistent implementation.

## **Conclusion**

Due respect for the principles of *transparency, effectiveness, proportionality* and *coherence* of the legislation adopted will ensure that the new regulatory structure has the chance to cure the main disease for which it was designed: incoherent, ambiguous and out-of-date legislation that fails to work on the ground. *Speed* is important but the ultimate verdict will hinge on *quality*.

## **2. Extension of the Lamfalussy process to banking and insurance**

### ***Background***

Commissioned by the ECOFIN Council, the EFC Report of October 2002 proposed extending the Lamfalussy process to the banking and insurance sectors with arrangements very similar to those already in operation in securities. Based on the experiences, outlined above, the main focus of industry response was on the formal process of consultation.

### ***Latest Developments***

On 6 November 2003 the Commission issued a press release detailing its legislative package for putting the new committee structure in place. The package consists of one Directive, which will replace references to the existing Committees in existing legislation, and six Commission Decisions establishing the new Level 2 and 3 Committees. The Commission is postponing adoption of the Decisions until the Directive has been adopted by Council and Parliament.

The package for establishing the new Committees has come very late in the day and it is questionable whether or not there is time for it to go through the co-decision process during the current parliamentary term. The Commission believes that the concerns of the European Parliament have been addressed and that, therefore, there should be no delay in finalising the Directive and advancing the new framework for banking and insurance.

### ***Financial Industry views***

Financial industry bodies have generally supported the extension of the Lamfalussy framework to banking and insurance. They argue that this provides an opportunity to deliver proportionate financial regulation and supervision of these sectors via a legislative framework which is able to keep pace with market developments.

Such support was however made subject by many in industry to the implementation of an improved accountability framework, amendment of Article 202 of the Treaty to safeguard the position of the European Parliament and a transparent and structured consultation process at all levels, supported by the involvement of market participants in appropriate technical fora. Article 135 of the Draft Constitution would allow the European Parliament to revoke the Commission's right to delegate implementing measures.

The review of the Lamfalussy framework for securities is due in April 2004. Industry is concerned that, if the extension to banking and insurance is also to be reviewed at that time, the track record will not be sufficient. There are no Lamfalussy directives for banking at the moment, as both Level 1 and Level 2 of the Capital Adequacy Directive will be put through the co-decision process. Any review for banking and insurance would probably need to take place later.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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