

EPFSF Briefing: The Lamfalussy Process - Is it working? The experience of the Market Abuse Directive (MAD) and other relevant Directives

Summary: *An innovative regulatory process created for EU securities legislation, now in the process of being extended to banking supervision, insurance and pensions, the Lamfalussy process is in a constant state of refinement. This briefing reviews the first three years of its application to securities, identifying objectives already achieved, those which have proved more challenging, and those not yet tested. Although there is room for improvement for all levels of the process implemented so far, it is also clear that we have yet to exploit its full potential, which will only be possible once the constraints of FSAP deadlines are past and we make use of additional features of the process, such as its adaptability. There is general agreement that implementing the Lamfalussy process in full is the only way forward: turning back is not an option.*

A. Background

What are the objectives of the Lamfalussy process? Triggered by the pressure of adopting 42 FSAP measures in three years, it aims at more than simply “speedy” legislation: Its goal is **quality legislation that works**. To achieve this, it breaks up a legislative package into four “levels”:

- **Level 1:** Core principles adopted by normal co-decision (with scope for greater speed);
- **Level 2:** Implementing measures (directives or regulations) adopted by the European Commission that fill in technical details of Level 1, based on advice from the Committee of European Securities Regulators (CESR) and with opportunity for the European Parliament (EP) and the European Securities Committee (ESC) to provide input. This mechanism should facilitate quick adaptation to market changes;
- **Level 3:** Consistent application of EU law through supervisory convergence among securities regulators working under the umbrella of CESR;
- **Level 4:** Enforcement of timely and correct transposition of EU law by the Commission.

Supporting this structure is a framework for consultation and transparency to get input from market participants, investors and issuers. This should produce technically sound rules that achieve their policy objectives and generate net benefits for EU citizens, companies and the EU economy.

Given its novelty, it was clear that a continuing review of the implementation of the process would be needed to monitor and fine-tune it. The three reports of the Inter-institutional Monitoring Group (IIMG), the Commission’s recent launch of a “Lamfalussy review”, and CESR’s recent papers exploring its role at Level 3 are part of this clarification and improvement process.

The Lamfalussy process is being extended to banking supervision, insurance and pensions. Experience with the Lamfalussy process in securities markets will be particularly relevant to use of the process in banking regulation, where the Committee of European Banking Supervisors (CEBS) and the European Banking Committee (EBC) will have equivalent roles.

B. Experience of the Lamfalussy Process

The process has been applied to four Directives so far: MAD; Prospectus Directive (PD); Markets in Financial Instruments Directive (MiFID); and Transparency Obligations Directive (TOD). It is important to note, however, that **MAD and PD were adopted before the Lamfalussy process was formalised**. In particular, there was **no formal pre-consultation** on these proposals. Also, an assessment of experience of the process must recognise that the **tightness of the FSAP deadline** imposed an external constraint, which (it is to be hoped) would not exist for future measures.

1. What works?

- **Speed:** MAD was adopted in 19 months and MiFID in 17 months, compared with more than 24 months on average for co-decision measures. But PD, which was significantly revised during co-decision, took more than 25 months. The extensive consultation on the TOD made it possible for the EP to adopt the Directive in one reading, although its adoption still took 21 months.
- **Greater participation of market experts in policy and technical design via comprehensive consultation:** As regards both MAD and (particularly) PD, the EP played an important role in correcting technical problems which arose because of the lack of formal pre-consultation. The first true example of Lamfalussy-style consultation at the pre-legislative stage, MiFID, enabled the Commission to transform a very complex set of issues into a narrower range of questions for debate at co-decision.
- **Clear political agreement:** Thanks in large part to the distinction between core principles and technical rules, it was possible to establish the basis of a passport for cross-border issuers of capital in EU markets (PD) and a clearer passport for intermediaries (MiFID).

2. What are the challenges so far?

- **Better quality legislation:** The EP's role and market input at Levels 1 and 2 have helped to avoid some technical problems. For example, in MAD, "market abuse" was more clearly defined than in previous regimes so that it is easier to identify while providing necessary protection for innocent behaviour. In PD, severe problems in the initial proposal were removed during co-decision, but the impact of the approval and disclosure regime on the competitiveness of EU markets (particularly bond markets) remains to be seen.
- **Separating core principles from detail:** The relatively high level of detail and the lack of clarity in some parts of Level 1 MAD and PD are ascribed to the lack of prior consultation and the rush in adopting these laws. The significantly higher level of detail in Level 1 MiFID as compared to the first Investment Services Directive (ISD) was in some parts necessary for clarity, but in others due to a lack of trust in the lower levels of the process.
- **Consultation compressed by time constraints:** Too often the FSAP timetable has cut consultation short. In the preparation of the most complex Level 2 measures for MiFID (transparency rules), CESR was given two months less than the 12-month minimum time recommended by the IIMG and generally requested by CESR itself. This may lead to rushed consultation and inadequate discussion of technical points.
- **The role of Level 3:** As the most innovative but least defined layer of the process, Level 3 has generated concerns, especially regarding CESR's activities where there is no specific EU mandate. The CESR-ECB standards for clearing and settlement were criticised for entering into political principles not settled at, and possibly prejudicing the outcome of, potential Level 1 deliberations. CESR's consultations on Level 3 have highlighted the question of regulators' accountability vis-à-vis the EP and national parliaments; the need to focus Level 3 on greater coordination and consistency of approach by supervisors in performing the tasks and responsibilities given to them by EU legislation; and the need to provide CESR members sufficient flexibility to achieve supervisory convergence taking account of their accountability at national level.
- **Timely and accurate transposition of EU law:** Only four Member States have so far fully transposed MAD Level 1 and Level 2 (the deadline was 12 October 2004). So it is too early to assess whether the transposition will be accurate, although early indications suggest some divergence. The recently announced postponement of MiFID implementation by 12 months (welcomed as a necessary step for many practical reasons), as well as delays in MAD implementation, underscore the need for deadlines to take into account the minimum time needed by the Member States and the industry to prepare new systems and processes.

3. What remains to be tested?

- **Consistent implementation and enforcement:** With its PD guidelines of February 2005, CESR completes its first Level 3 work under an EU mandate. Level 3 guidelines for MAD, which are under way, cover most of the priority issues that could affect consistent implementation. Success of these and other Level 3 measures depends on effective convergence of supervisory practices through day-to-day cooperation, non-binding interpretations, and consensus-based work among supervisors. It is important that this process is not unduly restricted by prescriptive rules which cannot be applied sensibly and flexibly. The implementation of Level 4 is also to be tested. The Commission is adopting an active approach to this issue.
- **Adapting EU law to new developments:** A major selling point of the Lamfalussy proposals was the possibility of reviewing and updating Level 2 rules speedily. To date, there has not been time for using Level 2 in this way. It seems clear, however, that in order to allow Level 2 to function effectively in this way, excessive detail at Level 1 (or 2) should be avoided.

4. What does the future hold?

- **CESR's consultation on future models for supervisory convergence** was welcomed as a stimulus to a further debate on possible routes which the Lamfalussy Process might take in the long run and the mechanisms, models and resources that might be considered to achieve it under each scenario. But most agree that the focus, for the next few years, must remain on making the framework succeed as designed. Success depends in particular on better **implementation and enforcement**. This perspective fits well with CESR's and CEBS's stated roles, which emphasise the pragmatic approach and are designed to contribute to consistent implementation of EU law, convergence of supervisory practices, and stronger supervisory co-operation.
- There is also consensus that future use of the Lamfalussy process for **new legislative** proposals must benefit from **more realistic timetables**, thorough **market failure analysis** to establish whether there is a problem that requires a regulatory solution, thorough **regulatory impact analysis**, and a greater focus on separating **core principles** from **detail**. As recommended by the Lamfalussy Report, there is also a need to agree on the **core principles and objectives of securities legislation**.
- The new Constitution provides a clearer legal basis for Lamfalussy-type legislation which better reflects and protects the overall inter-institutional balance in the EU. Should its implementation be delayed, it is absolutely essential that there be a long-term arrangement to avoid, if at all possible, the need for "sunset clauses" in the future.

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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