Procedural Consumer Protection and Financial Market Supervision

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In the aftermath of the financial meltdown, the consensus was that regulation had failed. On the institutional side, the regulators throughout the world were taken by surprise, especially regarding the dimension of the crisis and its spill-over effect. On the substantive law side, the laws which were in place obviously didn’t prevent the crisis; indeed, the centerpiece of global bank regulation – the capital adequacy rules – turned out to act as a downward catalyst. As in every financial crises in the past, the primary response of the policy makers was to call for more regulators and more regulation. Some voices also argued for stronger consumer protection mechanisms. In Europe, the new financial architecture, encompassing both new regulatory bodies and regulatory law, is bound to become reality: On December 2, 2009, the EU finance ministers agreed to go forward with the Commission’s proposal to overhaul the financial market legislation and to create a new governance structure for the regulation and supervision of the financial markets. Whatever the final agreement of the Member States may look like, there is little doubt that the EU is taking a monumental step towards further federalization. This paper will focus on the question whether the new institutional design has an impact on consumer protection issues. It will do so by tracing the different steps of the institutional developments under a consumer protection perspective.

I. Instruments of Procedural Consumer Protection

Over the years, the European Union has developed a broad set of measures which can be categorized procedural consumer protection instruments. For the purpose of this paper, these instruments will be divided into three categories.

A first category regards Voice. It encompasses instruments which are designed to formally integrate consumer interests in the regulatory process by granting them direct representation at the level of policy-making and decision-making. A second category regards Action. This category regroups instruments which offer judicial remedies to the consumers or their representatives. Traditionally, the remedy has been to grant legal rights which translated into legal action by consumers in private courts. However, the remedy can also translate into claims against the regulatory agencies for proper implementation of EU law, or in actions against the regulatory agencies for damages suffered from failed supervision. The third and last category of consumer protection instruments regards Consideration. It means that issues of consumer protection are a general principle to be taken into account by regulators and legislators.

II. Bank Supervision and Financial Market Supervision

Before analyzing the institutional framework of the EU financial market legislation in the light of procedural consumer protection instruments, it is important to understand the specific regulatory background of this type of legislation – and the mind frame of the people and institutions which are in charge of implementing it.

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2 For a more detailed account of the development see the contribution of Takis Tridimas.
Historically, supervision in the financial world meant prudential bank supervision by national bank supervisors. With few exceptions, prudential bank supervision was not about consumer protection. It was about functional protection (to ensure that the markets were functioning) and about investor protection, understood as the protection of the depositors.

Financial market supervision is a relatively new concept. Although it had forerunners in the 1970s, it owes its development to the growth of the financial markets, which, in turn, was due to the new technologies of the 1990s. At that time, John Doe the depositor became John Doe the investor, more specifically: the small scale investor. As a consequence, consumer protection issues in the area of financial services started to emerge in an amplified manner. The supervisory authority, however, remained the same. It had a larger portfolio, but in essence it still perceived itself as a bank supervisor, and not as a general guardian of consumer issues. This mind-frame has to be taken into account when analyzing the question of institutional consumer protection.

III. Development of the Institutional Framework

1. Duty of Coordination between the Member States

The EU has a long history of taking a centralized approach to the (material) regulation of financial market activities: the first Banking Directive dates from 1977. In contrast, the supervisory structure has traditionally been decentralized – a notable exception being the principle of the home country control. Supervision has been a matter for the Member States, who are also free to choose their proper institutional design. This has the advantage of empowering the supervisors closest to the individual bank. However, since many banks had pan-European activities, cooperation among national supervisors has always been essential. Therefore, Community law requires the Member States to enter into written coordination and collaboration agreements in view of achieving an integrated financial market. As a result, a substantial number of bilateral Memoranda of Understanding (MoU) have come into existence. Quite recently, the EU banking supervisors have agreed on three multilateral MoU on financial crisis management.

2. The Lamfalussy Framework

a. General remarks

An important development in the design of the institutional framework came with the Financial Services Action Plan (1999) and the Lamfalussy framework (2002), also called Lamfalussy process, which followed it. The FSAP was a blueprint of the issues that needed to be harmonized in order to complete the single market in financial services. The Lamfalussy framework was designed to structure the coordination between the Member States and their connection to the legislative process on the EU level by introducing a four-level decision-making process which relied heavily on comitology
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procedures. Level one consists of the standard procedure of Commission proposals for framework principles. Usually, these will be directives, although they may also take the form of regulation. Level two operates on the basis of the combined knowledge and interests of the governments of the Member States, embodied in Committees: The European Banking Committee (EBC), the European Insurance and Occupational Pensions Committee (EIPOC), and the European Securities Committee (ESC). These committees give feedback and propose concretization of the level one principles. The measures have taken the form of directives or regulations. Level three consists of the representatives of the national supervisory authorities, which are again formed as committees: the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR), and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The three committees advise the Commission on the preparation of measures in their respective area of expertise, they work to enhance the coordination between the national authorities and, above all, they design the standards to ensure that there is a consistent implementation of the measures in the Member States. Level four is operated by the Commission which is in charge of the monitoring and enforcement in order to ensure that the measures decided at levels one and two are effectively implemented.

The process was a success and gained momentum in the new millennium, as important legislation came through: The Market Abuse Directive (2003), the Prospectus Directive (2003), the Transparency Directive (2004) and especially the Directive in Markets in Financial Services, MiFID (2004) with its goal to provide systemic investor protection. Through those key directives, a considerable degree of harmonization has been achieved. However, this regards only the substantive law. Neither the FSAP nor the Lamfalussy framework really changed the decentralized approach of the governance structure for financial regulation in Europe. For some, the FSAP and the Lamfalussy process, by increasing the level of legal harmonization and supervisory cooperation, actually enhanced the decentralized prudential arrangements.8

b. Consumer protection

Consumer protection groups are not a formal part of the decision-making process in the Lamfalussy process. This is not to say that consumers have no formal forum to communicate their views. One such platform is the Forum of User Experts in the Area of Financial Services (FIN-USE) which was created by the Commission in 2004 with the goal to integrate the views of consumers and small businesses in the EU policy-making.9 FIN-USE has been actively promoting consumer interests in its communication with the various EU bodies, especially the level three committee CERS.10 Also, in 2006, the Commission established a Financial Services Consumer Group.11 More recently, the level three committees have begun to include representatives of FIN-USE in their consultative panels.12 It

12 This is the case for the Committee of European Banking Supervisors (CEBS), see Bradeley, supra note 11, at 1232. In fact, the CEBS, the CERS and the CEIOPS are charged, by the Commission, to include consumer groups in the consultation process. See Kai P. Purnhagen/Paul Verbruggen, Europäische Gemeinschaft, in: H.-W. Micklitz et. al (eds.), supra note 3, 173-245, at 231.
has to be pointed out, however, that the representation in a consultative panel of a Committee does not, by far, yield the same influence as being part of its governing body.

As to the question whether private actions can be brought for failure to implement the laws passed at levels two and three (protection category „action”), there seems to be a consensus that this is perceivable for very few EU laws only (notably: the directive on MiFID) and is, in any event, a very difficult task.\(^{13}\)

The Lamfalussy framework did, however, stress in an unprecedented way the crucial importance of integrating consumer groups and consumer issues in the regulatory process. This is consistent with the Financial Services Action Plan, which marked the issue of consumer protection as a high priority.\(^{14}\) In its final report, the Committee of Wise Men stressed the need for cooperation and partnership among all stakeholders, explicitly including the consumer groups.\(^{15}\) Also, it proposed consultation procedures at all levels of the decision-making process.\(^{16}\) As has been pointed out above, consumer groups have indeed received more attention in the Lamfalussy framework than in the previous law-making process of the EU.

IV. Post-Crisis Proposals for a New Regulatory Architecture

1. The Big Picture

The recent financial meltdown created resulted in a global regulatory empowerment: Everywhere in the world there was the political momentum to fundamentally rethink the structure of financial supervision. The Commission, besides engaging in crises management, also saw a clear need for a new EU financial architecture. It instituted a high-level group on financial supervision in the EU, chaired by M. Larosière. The task of the high-level group was to issue recommendations on the reform of the system of financial supervision within the EU. The group released its report on February 2009.

On the basis of the report, the Commission issued two Communications on the new regulatory framework (in March and in May 2009). In September 2009, it presented a comprehensive package of reform proposals.\(^{17}\) The proposals consist of new substantive regulation (capital requirements, deposit guarantee schemes, credit rating agencies and alternative investment funds). On the institutional side, it proposes a new pan European regulatory framework. The framework establishes new regulatory bodies.

a. The European Systemic Risk Board

The European Systemic Risk Board will be in charge of the macro-prudential supervision of the financial sector in Europe.\(^{18}\) The Commission proposal\(^{19}\) stipulates that the ESRB will be chaired by the president of the European Central Bank; the members will mainly be the governors of the twenty-

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\(^{13}\) Purnhagen/Verbruggen, supra note 12, at 201 ss. and 234 ss.


\(^{16}\) See, e.g., the Final Report of the Committee of Wise Men, supra note 15, at 25, 32, 36, 42.

\(^{17}\) All documents available at [http://ec.europa.eu/internal_market/finances/committees/index_en.htm#package].

\(^{18}\) For an overview see Recine/Teixeira, supra note 8, at 15 ss.

\(^{19}\) For the Commission proposal see <http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_499_en.pdf>.
seven national central banks. Its core mandate is to monitor and analyze imbalances in the financial system and, especially, to detect „systemic risks“. In other words: The ESRB is supposed to recognize a bubble and act before it bursts. It is an extremely difficult task, as there is no generally accepted definition of the term „systemic risk“. It has rightfully been pointed out that „if a problem cannot be defined, it cannot be solved.“ The task is complicated further because it requires to transpose an already „fuzzy“ economic concept into a clear cut legal regulation. In the banking community, there is a widespread skepticism as to how the macro-prudential approach will work in practice. One newspaper cited a banker saying that „not only is macro-prudential regulation rubbish, but it gives rubbish a bad name.“

The ESRB will have the power to issue recommendations to deal with systemic risks. However, the proposal changes the mechanism for recommendation by using a regulatory tool which is well know in the prudential supervision of banks: It is the concept of „comply or explain.“ In other words: If the Commission doesn’t follow the recommendation, it has to explain itself. This changes the quality of a recommendation. And it also changes the status of the body that issues a recommendation. It may or may not be on purpose, but it reflects in the language. This body is not called a Committee, but a Board.

In spite of the skepticism regarding the workability of the ESRB, this part of the Commission proposal seems to have passed the deliberation by the EU finance ministers with little modifications.

b. European Supervisory Authorities

In addition to the macro-prudential supervision, the Commission proposes a new system of micro-prudential supervision. In micro-prudential supervision, the focus lies on the safety and soundness of individual institutions – as well as consumer protection. The micro-prudential supervision is to be carried out by new European supervisory authorities: The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA). These authorities will replace the level three committees of supervisors of the Lamfalussy procedure. According to the Commission proposal, each of these authorities will have independent legal personality. They will take on the tasks currently performed by the level three committees and, in addition, they will be allocated important decision-making, monitoring and even quasi-regulatory functions. As their level three predecessors, these new authorities will be based in Frankfurt, London and Paris.

The Commission presents the new framework differently. The proposal talks of two pillars, the macro-economic pillar with the European Systemic Risk Board and the micro-economic pillar with a body called the System of Financial Supervisors (ESFS). In the proposal, the second pillar is called „a network of national supervisors“. However, there is little doubt that it is not the network which is new and which will be the main pillar of the supervisory framework. The pillar – or rather the pillars – will

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21 See Schwarzc, supra note 20, at 197.

22 For a contribution of the legal scholarship on systemic risk see Schwarz, supra note 20, passim.

23 Financial Times [online edition], June 21, 2009 (Respinning the web).


be the new European Banking Authority, the new European Insurance and Occupational Pensions Authority, and in the new European Securities Authority.

c. Timetable

The ministers of finance agreed, on December 2, 2009, to go forward with a „revised version“ of the Commission proposal.26 The Council has charged the EU Presidency to start negotiations with the EU Parliament regarding the Commission proposal. The first reading is scheduled for April 4, 2010. The plenary session is scheduled for June 15, 2010.

2. The Fine Print

The fundamental changes in the regulatory structure are brought to light if one looks beyond the broad descriptions of the tasks (and powers) of the new prudential watchdogs. The European Securities and Markets Authority (ESMA) may serve as an example.

Among other things, ESMA will be in charge of the development of technical standards.27 The Commission staff working document provides an overview of the key areas which could be subject to the development of such standards.28 They include areas where detailed methodological or quantitative standards are required (e.g., internal models of capitalization of banks), areas where uniform reporting is deemed beneficial (e.g., uniform reporting format for banks), and areas such as risk assessment and information sharing.29 Generally speaking, technical standards do not involve policy decisions. Even if this were true, one should not underestimate their impact. By way of example: The numeral sequence of the international bank account number (IBAN) is a technical standard. This technical standard has ensured that the payment systems become interoperable, thus creating a level playing field among them.30

So far, technical standards have not been a binding instrument of law-making at the EU level. The present proposal, however, states that where the Commission decides not to endorse the standards submitted by ESMA or decides to amend them, it must provide reasons for its decision.31 The fact that ESMA will develop the standards using better regulation principles,32 including appropriate consultation, does not eliminate the risk of quasi legislation under the guise of technical standards – a risk which is even more serious in view of the “comply or explain” situation of the Commission. The Commission draft emphasizes that the technical standards will be limited to matters of highly technical nature.33 However, once ESMA is operative, there is no procedural safeguard to limit the technical standards to matters of highly technical nature – with the exception of the “veto” by the Commission.

Another task of ESMA is to ensure the consistent application of Community rules. The draft foresees a three-step enforcement procedure: (1) Where ESMA considers that a national supervisor does not

27 For the term „standard“ see art. 1.6 of 98/34/EC, as amended by 98/48/EC.
31 See Commission proposal, supra note 33, Art. 7 (1) subparagraph 4.
32 See 98/34/EC.
comply with the applicable Community rules, it may investigate the matter, and, if necessary, adopt a recommendation addressed to the national authority in question. (2) If the national supervisor does not comply, the Commission will step in. The national supervisor has then strict time limit to inform the Commission and ESMA of the steps that it has taken to comply with that decision. (3) Finally, if the national supervisor does not comply, ESMA can address the financial market participant individually requiring it to take the necessary action to comply with Community Law. The power of ESMA is extensive and it includes the power to require the entity in question to cease business. In other words, it can sidestep the national supervisor.

This part of the proposal has been revised in the course of the deliberation of the finance ministers. Notably Germany and France had been opposed to granting strong enforcement powers to the new authorities.34

3. Institutionalized Consumer Protection

The preliminary statement of the proposal to establish a European Securities and Markets Authority states that the Authority „should act with a view to improving the functioning of the internal market ... to protect investors ... to strengthen international supervisory coordination, for the benefit of the economy at large, including financial market participants and other stakeholders, consumers and employees. ...“ In view of the different consumer protection categories outlined above, this falls under the category „consideration“: Consumer issues are to be taken into account in the rulemaking on a general level.

The new framework does not explicitly contain provisions regarding possible claims of private persons or consumer groups with regard to the implementation of EU law by the Member States. However, it is conceivable that with the increasing volume and scope of EU legislation and also the increasing tendency of this regulation to set maximal standards instead of minimal standards,35 law suits for failure to implement EU law are more likely to succeed.

The truly new point of the proposed prudential framework is that, for the first time, consumer groups are formally included in the decision-making process. In the drawing of technical standards and in the design of a common rulebook, ESMA is supposed to consult with interested parties. The proposal includes the creation of a Securities and Markets Stakeholder Group (art. 22). In its present version, it reads as follows: „(1) For the purpose of consultation with stakeholders in areas relevant to the tasks of the Authority, a Securities and Markets Stakeholder Group shall be established. (2) The Securities and Markets Stakeholder Group shall be composed of 30 members, representing in balanced proportions Community financial market participants, their employees as well as consumers, investors and users of financial services. “ The proposal regarding the European Banking Authority (EBA) and the proposal regarding European Insurance and Occupational Pensions Authority (EIOPA) each include a parallel provision.36

The Stakeholder Groups may, at a first glance, be somewhat similar to the present consultative panels of the level three committees of the Lamfalussy framework.37 The difference, however, lies in the fact that the Stakeholder Groups are formally given a place at the level of the legislation establishing the three supervisory authorities, thereby giving them a more important role in the future governing process. Being part of those Stakeholder Groups means that consumer interests now have a platform

34 Financial Times Deutschland, December 8, 2008, at 15.
35 A prominent consumer-relevant example is MiFID, which is seen, at least by some authors, as maximum standard regulation. See Peter O. Mülbert, Auswirkungen der MiFID-Rechtsakte für Vertriebsvergütungen im Effektengeschäft der Kreditinstitute, ZHR 172 (2008), 170 - 209, at 177.
36 Both at art. 22. For the full text see: <http://ec.europa.eu/internal_market/finances/committees/index_en.htm#package>.
37 See supra at 21 (Consumer protection).
which is more visible and which cannot easily be sidestepped. This, in turn, enhances its overall position in the policy and decision-making. On the other hand, it has been rightfully pointed out that this does not change the imbalance between industry and consumers with regard to resources. In its response to the proposed new system of governance, FIN-USE has suggested that the proposal should include wording which defines as a key objective of the Stakeholder Groups that they should provide insight to the authorities regarding the impact of consultations and initiatives on consumers and users, and ensure that the decision-making process takes those interests into account.\(^{38}\) Another issue, according to FIN-USE, concerns the „balanced proportion“ of interests which are represented in the Stakeholder Groups. In order to ensure that consumer interests are adequately represented, a quota of one third should be reserved to the consumer representatives on the Group level, whereas no more than one third of the members should be from the financial services industry on the Board level.\(^{39}\) Also, on very practical terms and in view of the unequal resources, the Stakeholder Groups should be given secretarial support and their members should be compensated for the attendance of Group meetings.\(^{40}\)

\[\text{V. Conclusion}\]

The recent development in the prudential supervision of the financial services sector reflects a fundamental change in the role of consumers and consumer interest groups. For the first time, consumer interests are a formal part of the decision-making process. This does not transform the new institutional framework into a consumer protection platform. Indeed, the impact of the formal inclusion of consumer interests within the wide group of stakeholder interests should not be overestimated. This is even more so if one considers that the Stakeholder Group, as designed in the proposal, only has a consultative role. On the other hand, it does give consumer protection issues an institutionalized voice. Considering the fact that other interest groups, namely the professional service providers, have levels of resources available that clearly favors them in terms of informal agenda-setting and decision-making, this is an important first step. It must be hoped that the final version of the new institutional framework does not downgrade or water down this element of representation. In terms of power, agenda-setting and decision-making, consumers are certainly not the main players in the EU. Yet they are at the heart of the concept of an internal market. Accordingly, they should be among its primary beneficiaries.


\(^{39}\) FIN-USE, supra note 38.

\(^{40}\) FIN-USE, supra note 38.
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