FIDE 2014

General Topic 1

The economic and monetary union: constitutional and institutional aspects of the economic governance within the EU

United Kingdom National Report

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Introduction

There is a range of complex factors which affect the writing of a national report, from the UK perspective, on EMU governance questions.

The first set of factors concerns the inherent complexity of the EU response to the financial crisis. A broad mixture of legal instruments have been employed, partly on the basis of the EU Treaties, but also partly outside the strict EU law framework. Those instruments involve the EU institutions, the Member States, but also novel institutions and bodies, such as the EFSF and the ESM. It is, indeed, trite, and amply described in the Questionnaire and in the literature, that the EU's current economic and monetary governance system is a result of a lot of ad hoc *bricolage*. [1]

A second layer of complexity is a function of the UK's very special position vis-à-vis EMU governance. Here is a Member State with a permanent opt-out from the single currency, with no prospect of ever joining the euro on any perceptible political horizon. It is a Member State which refuses to participate in the construction of a Banking Union, but which depends on its financial services industry for prosperity and has a keen interest in the internal market for such services, and in protecting the City of London as a global financial centre. It is a Member State whose current government subscribes to austerity, but has declined to sign up to the Treaty on Stability, Co-ordination, and Governance (hereafter referred to as the Fiscal Compact). It is a Member State which preaches greater EU flexibility, [2] but dislikes that EMU governance may be shifting towards the Eurozone, with the attendant decision-making confined to the Eurozone Member States. It is a Member State with a strong economic interest in a thriving Eurozone, but which stands on the sidelines watching the construction of the Eurozone's governance system.

A third element making the writing of this report more complex is the unsettled nature of the emerging governance system. It is true that, at the start of 2014,

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[1] Pisany-Ferry, as quoted in J-V Louis and R Lastra, 'European Economic and Monetary Union : History, Trends, Prospects' (2013) 32 Yearbook of European Law 196.
[2] See the Prime Minister's speech on Europe, https://www.gov.uk/government/speeches/eu-speech-at-bloomberg.

many parts of the system have, in political terms, been put in place. But for purposes of a constitutional and institutional assessment, from a legal perspective, the system continues to be in its infancy. Many legal instruments are not yet finalised, others have hardly been implemented as yet, and important case law is no doubt still to come.

In the face of this range of complex factors, the aims of this report are modest. It is not our intention to analyse every conceivable issue regarding the UK's position towards EMU governance. We aim to discuss some of the main issues, with a view to introducing, and occasionally clarifying, the core debates. We do this from an academic perspective - as academics based in the UK (but not UK nationals!). With that hat on we do not shy away from personally commenting on some of the constitutional and institutional questions which the new system of EMU governance throws up. For a couple of those, the "UK" perspective is present in the sense that those questions have also been considered by other UK academics. Obviously, we also aim to refer to the "official" UK government position, where there is one. But we feel that it is equally important to take on board the views expressed in the wider UK political, financial, and indeed academic community.

Our report is guided by the Questionnaire, but does not attempt to cover all the questions and subquestions. Some of them are not strictly relevant for non-Eurozone Member States, others are less interesting from a UK perspective, and still others are, frankly, beyond our current knowledge or expertise. We have instead aimed to produce a readable report, which aims to contribute to the debate on EMU governance in a more selective way - whilst aiming not to do too much injustice to our original remit and to the impressive and comprehensive Questionnaire.

One last introductory point. Prior to tackling the Questions, we thought it would be useful to set out, in a schematic way, the extent of the UK's participation and non-participation in EMU governance. The political headline that the UK is not part of the Eurozone masks a complex of "ins" and "outs", some understanding of which is essential for a further analysis of the UK's position.

The "ins" and "outs" of the UK's position in EMU governance

- Protocol 15 to the Treaties sets out the extent of the exemptions from which the UK benefits in relation to EMU. It provides that the UK "shall retain its powers in the field of monetary policy according to national law" (paragraph 3). It further exempts the UK from a number of TFEU provisions on economic and monetary policy. They include inter alia:
    - Art 119(2) TFEU on the single currency and the single monetary policy;
    - Art 126(1) TFEU, according to which the Member States "shall avoid excessive government deficits" - instead, Protocol 15 provides that the UK "*shall endeavour* to avoid an excessive government deficit" (paragraph 5, emphasis added). The UK is

also exempted from the Council's powers in Art 126(9) and (11) in case of failure to put into practice the Council's recommendations on a potential excessive deficit.

- Artt 127 to 133 TFEU on monetary policy, but with the exception of Art 127(6) concerning the conferral of specific tasks upon the ECB concerning policies relating to the prudential supervision of credit institutions. This for example means that the UK participated in the adoption of Regulation 1024/2013 on the Single Supervisory Mechanism (SSM), even if it will not be subject to that Regulation as it does not participate in the Banking Union.
- Art 138 TFEU on external representation of the EU on EMU matters and Art 219 TFEU on external exchange-rate agreements etc.
- Art 121 TFEU, on Council recommendations on broad guidelines of economic policies, "as regards the adoption of the parts of the broad economic policy guidelines which concern the euro area generally" (paragraph 4).
- Art 123 TFEU (prohibition of monetary financing), in the sense that the UK may maintain its 'ways and means' facility with the Bank of England (paragraph 10).

- The position of the UK is therefore comparable, but not identical, to that of the Member States "with a derogation" (Art 139 TFEU) which do not qualify for eurozone membership as yet.
- The special position of the UK is also reflected in the so-called Six Pack. Not only is the UK not subject to those regulations which only apply to Eurozone Member States; [3] it is also only partially subject to Directive 2011/85 on requirements for budgetary frameworks of the Member States. The chapter on numerical fiscal rules does not apply to the UK, because, as stated in the preamble, the excessive deficit reference values (3% deficit, 60% debt) "are not directly binding on the United Kingdom" (recital 17). The UK is a non-participating Member State for the purposes of Regulation 1175/2011 on surveillance of budgetary positions and the surveillance and coordination of economic policies; of Regulation 1177/2011 on the excessive deficit procedure; and of Regulation 1176/2011 on the prevention and correction of macroeconomic imbalances. All of this means that the UK is also subject to the European Semester, but in the mildest of ways (non-enforcible Council recommendations).
- The so-called Two Pack is limited to Eurozone Member States, and therefore does not apply to the UK.
- The UK participated in the decision-making process which led to the creation of the European Financial Stability Mechanism (EFSM), as this was done by means of a regulation adopted on the basis of Article 122(2) TFEU. [4] However, it did not participate in the creation of the European Financial Stability Facility (EFSF - a private company

[3] Regulation 1173/2011 on the effective enforcement of budgetary surveillance in the euro area and Regulation 1174/2011 on enforcement measures to correct excessive macroeconomic imbalances.
[4] Regulation 407/2010.

established in Luxembourg), and did not sign up to the Treaty establishing a European Stability Mechanism (ESM). It must be noted, though, that all EU Member States, including the UK, consented to the ESM Treaty referring to and making use of some of the EU institutions (the Commission and the ECB). [5] Of course, the UK also approved the amendment to Article 136 TFEU, introducing a paragraph 3 permitting the Member States to set up (effectively) the ESM.

- The UK did not sign up to the Treaty on Stability, Coordination and Governance (TSCG, or Fiscal Compact) - joined only by the Czech Republic. In contrast with the ESM Treaty, the UK did not formally agree to the use of the EU institutions for which the Fiscal Compact provides (see further below, under Questions 1 and 2).
- The UK does not, generally, participate in the Banking Union project. However, due to the close interrelationship between EU financial services legislation adopted in the internal-market framework and Banking Union, that non-participation is not absolute:
    - As mentioned above, Regulation 1024/2013 on the ECB's new role regarding prudential supervision (part of the SSM) is adopted on the basis of Art 127(6) TFEU, with the UK's participation in its adoption - but not in supervision itself.
    - Regulation 1022/2013, modifying the tasks and decision-making processes of the European Banking Authority (EBA) is adopted on the basis of Art 114 TFEU, with the participation of the UK. This regulation introduces the so-called double majority rule (majority of Eurozone Council members, and of non-Eurozone Council members), in order to maintain the integrity of the internal market and avoid Eurozone dominance of EBA decision-making.
    - The regulation on a Single Resolution Mechanism (SRM) is also intended to be adopted on the basis of Art 114 TFEU, therefore with the participation of the UK in its adoption. The UK will not participate in the single resolution fund, which will be set up by intergovernmental agreement.
    - The UK participates in the adoption of the Bank Recovery and Resolution Directive, which is internal-market-based, and will apply to all 28 Member States.
- The UK does not participate in the Euro+ Pact.

Questions 1 and 2: EU and non-EU instruments, constitutional and institutional implications

Questions 1 and 2 raise a number of issues concerning the scope of the EU's competences in matters of monetary and economic policy, and the use of a mixed bag of instruments - some EU Treaties-based, others intergovernmental or even private-law-based. The questions and subquestions are not limited to inquiring about the particular national perspective of the rapporteurs. We therefore take the opportunity to express

[5] Council Doc 12114/11, 24 June 2011.

a view on how the law has developed in this area, where need be (and possible) with reference to the UK perspective.

We consider that any analysis of the issues raised by these questions needs to start with an analysis of the CJEU's *Pringle* judgment. [6] In that ruling the Court focused on many of these issues, and any attempt to answer the questions has to begin with unpacking the reasoning in *Pringle*. We will look at the Court's construction of the EU's competences in matters of monetary policy and economic policy; at its analysis of the implied powers doctrine, as applied to the ESM; at its interpretation of the no-bailout clause (Art 125 TFEU); at its position on the use of EU institutions outside the framework of the EU Treaties; and at its finding that the ESM is not subject to the EU Charter of Fundamental Rights.

At the outset of our analysis, we should like to state that, with greatest respect to the Court's impressive judicial effort, an alternative approach was conceivable and arguably preferable: one which conceived of the ESM Treaty as affecting, in a number of ways, exclusive EU competences. The Court could have accepted, under such an approach, that the Treaty amendment (Art 136(6) TFEU) duly empowered the Member States to act in areas of exclusive competence. The upshot would have been to conceive of the ESM Treaty as structurally linked to primary EU law, in stronger ways than is the case at present. This would have consequences for e.g. the application of the Charter of Fundamental Rights, and for enabling the EU to develop its monetary and economic policies in a more coherent and enabling, primary-law governed set-up.

Pringle and the concepts of monetary policy and economic policy

The Court considered that, if the amendment to Art 136 TFEU were concerned with monetary policy, it would have encroached on the EU's exclusive competence as laid down in Art 3(1)(c) TFEU, and could not have been adopted under the so-called simplified revision procedure (para 52). That is the starting-point of the Court's analysis of the scope of the EU's monetary policy competences. It means that if the Court had found that the amendment does concern or affect EU monetary policy, the amendment would have been unawful for failure to use the right treaty-amendment procedure.

The Opinion of Kokott AG shows that an alternative starting-point was conceivable. As she pointed out, even in areas of exclusive competence the Member States may be empowered to act (Art 2(1) TFEU; paras 50-52 of the Opinion). It is difficult to see why such an empowerment could not result from primary law, given that it is accepted that EU legislation may allow the Member States to act in areas of EU exclusive competence. The latter has

[6] Case C-370/12 *Thomas Pringle v Government of Ireland*, judgment of 27 November 2012, not yet reported. Unfortunately, the UK's submissions to the Court have not been published, nor were we able to obtain them. It is regrettable that at the level of the Court there is no centrally organised access to such documents, which are clearly in the public interest.

been the practice in the field of the common commercial policy: in the very long transitional period leading up to a fully uniform commercial policy; [7] and today as regards the maintenance in force, and amendment, of bilateral investment treaties, in the face of the extension of the common commercial policy to foreign direct investment. [8] Therefore, a Treaty empowerment in Part Two of the TFEU, resulting from the amendment to Art 136 TFEU, by definition does not encroach on the EU's exclusive competences, as defined in Part One.

The Court analyses the scope of the EU's monetary policy purely by reference to the primary objective of maintaining price stability. It distinguishes the provision of financial assistance as aiming at the stability of the euro area as a whole, which is clearly distinct from the price stability objective. It finds - without much reasoning - that the grant of financial assistance to a Member State clearly does not fall within monetary policy. It then points out that such assistance complements the EU's economic policy, which is intended to consolidate macroeconomic stability and the sustainability of public finances. That policy is largely preventive, whereas the stability mechanism envisaged by Art 136(3) TFEU concerns the management of financial crises. That amendment therefore concerns economic, and not monetary policy (paras 54-60).

We are concerned that the Court has interpreted the scope of the EU's monetary policy in an unsatisfactory way. It is hard to see in what way the objective of maintaining price stability determines what is a monetary policy instrument, and what not. Any economic textbook will explain that price stability is determined, not only by monetary policy, but also, for example, by fiscal policy. But of course the Member States' fiscal policies are not thereby within the EU's exclusive competence in matters of monetary policy. Moreover, the objective of the EU's monetary policy is solely defined in terms of price stability, but other nations' monetary policies also aim at other objectives, such as maximum employment. [9] That does not however lead to a finding that employment policy is monetary policy.

Instead, the Court could have focused more on the nature of the support which the stability mechanism is intended to provide, and the instruments which are part of monetary policy. The ESM is often described as the EU's own IMF. [10] That certainly suggests a close link with monetary policy. However, it is also clear that the ESM, in the way in which it was set up, does not create money nor is it part of the monetary supply process. This is so because it borrows in capital markets and Member States guarantee such borrowing. It was not given a banking charter, and therefore cannot obtain

[7] P Eeckhout, *The EU Internal Market and International Trade - A Legal Analysis* (OUP 1994) chs 5 and 6.
[8] Regulation 1219/2012 [2012] OJ L 351/40.
[9] See e.g. the US Federal Reserve, see http://www.federalreserve.gov/pf/pdf/pf_2.pdf.
[10] See e.g. P De Grauwe, 'Governance of a Fragile Eurozone', 4 May 2011, http://www.ceps.eu/book/governance-fragile-eurozone.

liquidity from the ECB. [11] This shows that the ESM is not, as such, a monetary institution.

However, the amendment to Art 136 TFEU does not define the nature of the financial assistance which the Member States may provide, and the Court did not - rightly - focus on the actual ESM when determining the scope of monetary policy. Further, even if the ESM is not a monetary institution as such, its functions are so closely linked to monetary union that the finding that the Treaty amendment and its implementation are completely outside the scope of EU monetary policy is unpersuasive. Art 136(3) is limited to the eurozone Member States. The stability mechanism is intended "to safeguard the stability of the euro area as a whole" - indicating that it is aimed at maintaining the very existence of the euro. The nature of the financial assistance under the mechanism is not defined, meaning that a system could be set up which is genuinely monetary. We would therefore argue that the permission to set up a stability mechanism is sufficiently closely linked to EU monetary policy for the EU's exclusive competence in that field to be in issue. However, as mentioned above, that would not mean that the amendment could not have been passed through the simplified revision procedure. It would, though, mean that the EU's empowerment turns the use which the Member States make of that empowerment into a form of implementation of EU law, with all that this involves in terms of the application of relevant EU law principles. Such an approach would render the ESM Treaty much less intergovernmental than it is conceived at present.

The restrictive interpretation by the Court of the scope of the EU's monetary policy leads to its finding that Art 136(3) TFEU is within the sphere of economic policy. The Court here emphasizes that the EU's role is restricted, under Artt 2(3) and 5(1) TFEU to adopt coordinating measures (para 64). It further establishes that no Treaty provision confers on the EU the competence to establish a permanent stability mechanism (paras 64-67). In contrast with the Advocate General, the Court does not dwell on the nature of the EU's competence in matters of economic policy, though it seems to endorse the Advocate General's View according to which the EU's competence is not shared (let alone exclusive), but of a lesser nature: mere coordination (para 93 of the View). Art 2(3) TFEU appears to confirm this, by speaking about economic-policy coordination separately from the concept of shared competences (Art 2(2) TFEU).

All of this means that the Court's interpretation of the scope of the EU's EMU competences actually provide the Union with very few tools to maintain the stability of the eurozone and to safeguard the monetary union project. That interpretation does not assist in the process of remedying some of the birth defects of EMU. It pushes that process (or accepts that it is pushed) outside the EU law framework. It is true that the Court emphasizes that EU law needs to be respected by the Member States (see e.g. para 69), but it is nevertheless clear that such respect is more difficult to enforce in the case of intergovernmental agreements. For example, it is not obvious to us that

[11] We owe this insight to Prof Paul De Grauwe, London School of Economics.

private parties affected by an ESM decision could bring an action in the national courts, given that the ESM has legal personality, and is thereby separate from the Member States.

Implied treaty-making powers

The Court's analysis in *Pringle* of the question whether the ESM Treaty is caught by Art 3(2) TFEU insofar as it may affect EU law rules or alter their scope is short and, frankly, disappointing. Art 3(2) codifies the Court's case law on exclusive implied powers, the terms "affect" and "alter their scope" being copied from the seminal *AETR* judgment. [12] There are two basic issues with which the Court was confronted. The first is whether Art 3(2), and the case law on which it is based, extend to the kind of agreements such as the ESM Treaty, i.e. an inter-se agreement between (some of the) Member States, rather than an agreement with a third country. The second is the actual test which such agreements need to pass.

On the first point, the Advocate General pointed out that Art 3(2) TFEU, read together with Art 216(1) TFEU, "solely governs the exclusive competence of the Union for agreements with third countries and international organisations" (para 98). The Court, by contrast, focuses merely on Art 3(2), which speaks generally about the conclusion of international agreements. However, that does not mean that the Court overlooked the fact that Art 216 refers to "external" agreements only. At para 101 the Court states that it follows from Art 3(2) TFEU "that Member States are prohibited from concluding an agreement between themselves which might affect common rules or alter their scope". The fact that the Court adds the terms "between themselves" suggests that the Court sought to extend the principle of Art 3(2) TFEU to *inter se* agreements, between some or all the Member States. [13]

From a purely textual perspective, this is a remarkable shortcut. Art 3(2) TFEU defines the EU's exclusive competence to conclude certain international agreements. As such, that competence cannot extend to *inter se* agreements between some or all Member States. Which would be the other contracting party to the agreement with which the EU would be concluding the agreement? The Union cannot conclude agreements with itself. Textually, the application of Art 3(2) would only make sense if that provision stated that *the Member States* are precluded from concluding an international agreement in the situations which it envisages. Instead, the provision speaks of the EU's exclusive competence to conclude international agreements, which can only mean agreements with third parties.

However, that does not mean that the Member States are free to conclude any kind of *inter se* agreement. Such an agreement must comply with EU law, and must - it could be argued - not "affect" EU law or "alter its scope". But

[12] Case 22/70 *Commission v Council* [1972] ECR 263.
[13] Contra B de Witte and T Beukers, 'The Court of Justice approves the creation of the European Stability Mechanism outside the EU legal order : *Pringle*' (2013) 50 CMLRev 805, 834.

that is an argument which must be articulated, as to the principle's legal basis, its scope, whether it is coterminous with the principle applying to "external agreements", etc.

The basic rationale for the *AETR* principle is clear. If the Member States were capable of concluding an international agreement which "affects" EU law, there is a risk to the uniform and consistent application of EU law. [14] That risk is not eliminated by the simple operation of direct effect and primacy, which ensure that EU law is complied with. The Member State which has concluded an agreement in breach of the *AETR* principle may find itself in a difficult position on the international plane, and may be subject to conflicting obligations (EU law obligations conflicting with international law obligations). That particular rationale for the *AETR* principle is not present in the case of *inter se* agreements: as the parties to such agreements are EU Member States only, there is no third party which is not bound by EU law, and which could require compliance with the commitments entered into.

However, that does not mean that there are no other reasons for extending the *AETR* principle to *inter se* agreements. Clearly, the uniformity and consistency of EU law are not aided by an agreement between the Member States which, in its subject-matter, is too proximate to EU law norms, be they located in the founding Treaties or in EU legislation.

There is no space here to examine to what extent the pre-emption principle of *AETR* ought to be applied to *inter se* agreements. If however the Court simply extended *AETR* to such agreements, as it appears to have done in *Pringle* by not in any way qualifying the Art 3(2) TFEU principle, then its application of that principle was most cursory and not in line with the implied-powers case law. The latter casts the net widely, and does not require any conflict between the provisions of an international agreement and EU law norms. Even a disconnection clause, which aims to preclude conflict, is insufficient for avoiding the *AETR* principle. [15] The case law also takes into account the potential future development of EU law, in the area concerned. [16] Advocate General Tizzano has spoken about areas which are contiguous to EU legislation. [17]

To us it seems that the ESM Treaty is sufficiently close to EU law norms to be capable of "affecting" them or "altering their scope". The conditionality which it puts forward as the cornerstone of any financial assistance is very closely linked to the obligations which are imposed on the Eurozone Member States under the Sixpack and the Twopack. The fact that the Commission and the ECB are closely involved with the operation of the ESM only confirms the close connection with EMU governance. The Court could therefore have found that, on this basis too, there is EU exclusive competence. Again, the Member States could be duly empowered to exercise EU exclusive

[14] Opinion 1/03 re Lugano Convention [2006] ECR I-1145, para 128.
[15] Opinion 1/03, para 130.
[16] Opinion 1/03, para 126.
[17] Opinion in the Open Skies cases, Case C-466/98 *Commission v United Kingdom* [2002] ECR I-9427, para 75.

competence, and Art 136(3) does precisely that. The advantage, though, of such a conception would be that the ESM Treaty would be regarded as fully subject to EU law.

Admittedly, the Court did examine, in *Pringle*, whether the ESM Treaty complies with EU law. Nevertheless, a finding of exclusive competence would have created a stronger structural link between the ESM Treaty and EU law than exists at present.

Lastly, even if the finding of exclusive competence, resulting from a closer scrutiny of the *AETR* conditions, might not have made much of a difference in *Pringle*, it would have been relevant to other non-EU instruments such as the Fiscal Compact. The difference between the ESM Treaty and the Fiscal Compact is of course that there was no Treaty empowerment for the Member States to adopt the latter.

<u>The interpretation of the “no bail-out” clause (Art 125 TFEU)</u>

In the *Pringle* judgment the Court also analysed whether the ESM Treaty complies with Artt 122, 123 and 125 TFEU. By far the most significant analysis concerns Art 125, the so-called “no bail-out” clause. We are not aware of any clear United Kingdom position on the interpretation of that provision. The Court’s analysis is to us convincing, in particular as regards the general finding that the ESM financial assistance mechanisms are not in breach of that clause. Indeed, it would be awkward to argue the opposite, for essentially two reasons. The first is that it would lead to a reading whereby the Member States are not entitled to take action considered necessary to protect and even save the euro project as such. Art 125 TFEU is designed to further the success and survival of monetary union, not to destroy it. The second is that the Member States, by amending Art 136 TFEU, have modified the TFEU so as to enable them to offer financial assistance under the conditions for which the ESM Treaty provides. Artt 125 and 136(3) TFEU need to be read harmoniously, as they have equal legal status. The strict conditionality imposed by the ESM Treaty clearly does about as much as is conceivable to protect the function of Art 125, i.e. to maintain national budgetary discipline. If anything, the Court’s strong emphasis on conditionality could perhaps be seen by some as too much on the side of an “austerity Union”.

<u>The use of EU institutions</u>

The ESM Treaty makes use of three EU institutions: the Commission, the ECB and the Court of Justice. A decision of the representatives of the governments of the Member States records their agreement with such use. [18] This, by the way, is in contrast with the Fiscal Compact, for which there is no such agreement. The position of the United Kingdom is that the use of the EU

[18] See Council Cover Note of 24 June 2011, Document-No 12114/11, and recital 10 in the preamble to the ESM Treaty.

institutions outside the EU Treaties requires the consent of all the Member States. [19] To our knowledge, however, the United Kingdom has not pursued this in any of its legal challenges.

Advocate General Kokott considered it significant that there is a decision demonstrating sufficient collective action on the part of the Member States (para 173 of her View). She referred to the Court's *Bangladesh* and *Lomé IV* judgments, which each accepted that the Member States (all of them) could entrust certain tasks to the Commission. [20] The Court, by contrast, did not refer to the decision, and did not appear to require that the authorization be given by *all* Member States to make use of an EU institution outside the framework of the founding Treaties. All the Court did was to refer to the *Bangladesh* and *Lomé IV* precedents, as well as three Opinions analysing changes to the roles of the EU institutions. [21] From these precedents the Court deduced that the Member States are entitled to entrust certain tasks to EU institutions, outside the EU framework, provided three conditions are fulfilled:

a) the EU must not have an exclusive competence in the area concerned;
b) the relevant institutions do not make decisions of their own;
c) and the tasks do not alter the essential character of the powers conferred on those institutions by the founding Treaties.

It is not clear though that the case law referred to stands for these three propositions. The three Opinions concerned international agreements, to be concluded by the EU itself. It is from those Opinions that the Court derives the third principle; the Court is however taking that principle one step further by accepting that the *Member States*, rather than the EU, may entrust new tasks to the institutions provided that the essential character of their powers is not altered. From a constitutional perspective it is wholly appropriate that the Treaties themselves, where amended, or agreements concluded by the EU, or indeed legislation made under the Treaties, may entrust new tasks to the institutions. It is a different proposition that this may be done by the Member States acting outside the EU Treaties.

The *Bangladesh* and *Lomé IV* precedents are not strong either. Both cases turned on whether the Parliament's prerogatives were violated, as was required by the then principle for the Parliament to be entitled to bring an action for annulment. The *Bangladesh* case concerned humanitarian aid, provided by the Member States, but coordinated by the Commission. The Greek aid had been channelled through the then Community budget, without involving the Parliament. The Court, following the Opinion of Advocate

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[19] S Peers, 'Towards a New Form of EU Law?: The Use of EU Institutions outside the EU Legal Framework' (2013) 9 EuConst 37, 53-54.
[20] Joined Cases C-181/91 and C-248/91 *Parliament v Council and Commission* [1993] ECR I-3685 (*Bangladesh*) and Case C-316/91 *Parliament v Council* [1994] ECR I-625 (*Lomé IV*).
[21] At para 158 of the judgment; the references are to Opinion 1/92 [1992] ECR I-2821, paras 32 and 41; Opinion 1/00 [2002] ECR I-3493, para 20; and Opinion 1/09, not yet reported, para 75.

General Jacobs, simply found that the Greek aid was not Community revenue, and its disbursement not Community expenditure, and the said channelling could therefore not violate the Parliament's budgetary prerogatives. The *Lomé IV* case concerned a mixed agreement, the Court accepting that the development aid for which it provided could originate from the Member States, and that its disbursement constituted a kind of joint action, outside the Community budget. All that can be derived from these judgments is that the Court, in the particular contexts in issue, did not object to the entrusting of certain executive tasks to the Commission.

There has been a debate among UK academics as to whether the Court's liberal approach towards the use of EU institutions outside the EU law framework is correct and appropriate. Paul Craig has written about both the Fiscal Compact and the *Pringle* judgment, developing a series of principled arguments challenging the liberal approach. [22] Steve Peers, on the other hand, is more sympathetic. [23] Within the confines of this report it is impossible to do the debate any real justice, even by summarising the main arguments. The reader is referred to these writings, and in particular to Paul Craig's impressive critique. To us it seems that that critique is essentially right, and that the lawfulness and constitutionality of the conferral of extra-EU powers on the Commission and the ECB, particularly by the Fiscal Compact, are questionable. The latter has not been agreed to by all Member States, and to a large extent duplicates the EU law instruments for economic governance. Its adoption has subverted the Treaty amendment process – in so far as it contains provisions equivalent to those in the Treaties – and the EU legislative process – in so far as the Fiscal Compact contains provisions which could be adopted by way of EU legislation; or indeed by way of enhanced cooperation. The constitutional rigour and concepts of representative democracy which the Treaty of Lisbon introduced have been circumvented just a few years after its entry into force.

But also as regards the ESM Treaty, the Court's analysis may have unfortunate consequences. The Court considers that the ESM Treaty does not enable the Commission and the ECB "any power to make decisions of their own", and that their activities within the ESM Treaty "solely commit the ESM" (para 161). That is a rather formalistic conception of the tasks conferred on these institutions, in particular as regards the negotiation of MoUs with Member States requiring financial assistance. There is a serious risk that this renders ESM decisions unreviewable. The Member States participating in the ESM may well hide behind the ESM's legal personality, and the Court does not seem prepared to hold that the actions of the Commission and the ECB will be reviewable. As to the finding that the ESM Treaty does "not alter the essential character of the powers conferred" on the Commission and the ECB (para 162), that may well be the case, but the main question seems to us to be whether those powers are *exercised* in accordance with the founding Treaties; not just whether they are *altered*.

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[22] P Craig, 'The Stability, Coordination and Governance Treaty: principle, politics and pragmatism' (2012) 37 (3) ELRev 231-248; '*Pringle* and Use of EU Institutions outside the EU Legal Framework: Foundations, Procedure and Substance' (2013) 9 EuConst 263-284;
[23] Peers (cited above).

Lastly, the *Pringle* judgment also accepts the role allocated to the Court itself. In light of the express wording of Art 273 TFEU, and the opportunity which a wide conception of its own jurisdiction gives the Court to review ESM decisions and to uphold EU law, that acceptance is to be welcomed.

The Charter of Fundamental Rights

In *Pringle* the Court did not accept that the Member States where "implementing Union law", for the purposes of the Charter, when establishing the ESM. This was so because the founding Treaties do not confer any specific competence on the EU to do so (para 180). This finding has the unfortunate consequence that the ESM is not bound by the Charter. Given the potential for ESM decisions to interfere, through conditionality, with fundamental rights – in particular social and economic rights [24] – the Court's finding is, with respect, hard to accept. The EU has proudly proclaimed the Charter, and has made it legally binding, as an instrument intended to protect EU citizens from fundamental rights violations. It is no doubt difficult to explain to the ordinary citizen in bailed-out Member States that such bail-outs, and the conditions which they impose, do not emanate from the EU. A different approach was definitely conceivable. The Court has identified the close link between the ESM and EU-regulated conditionality. It is therefore difficult to accept that the Member States are not, to some degree, implementing EU law when bailing out another Member State by means of ESM support. Moreover, the Commission and the ECB participate in such bail-outs, and as institutions of the EU they are in any event bound by the Charter.

Question 5 and 10: the UK, Banking Union and financial regulation

Banking Union

From mid-2012, the most important policy development in response to the Eurozone crisis has been the Banking Union - widely regarded as central to deepening EMU. The UK has been supportive of the proposed Banking Union provided that it contributes to financial stability in the Eurozone and safeguards the UK's position in the single market.

The Banking Union is based on five components: a single rule book underpinning centralised supervision; a single framework for banking supervision of cross-border banks (Single Supervisory Mechanism, SSM); a common deposit guarantee scheme; a single framework for the managed resolution of banks and financial institutions[25] (Single Resolution Mechanism,

[24] See http://euobserver.com/social/122899, referring to a report by Prof Fischer-Lescano.
[25] Proposal of 13.07.2013, COM (2013) 520 final.

SRM), and a common fiscal backstop for temporary financial support of banks.[26]

The Banking Union involves a significant move towards supranational financial regulation, in potentially in lieu of a regulatory race-to-the bottom in the field of financial services. The supranational approach to supervision and resolution arguably represent a departure from the traditional mutual recognition model.

The Single Supervisory Mechanism

The Single Supervisory Mechanism confers new supervision tasks on the ECB. [27] Under the SSM, the ECB acquires important supervisory responsibilities. Its powers are divided into "investigatory powers" (Arts 9–12) and "specific supervisory powers" (Arts 13–15). The investigatory powers cover the ECB's right to periodically request data necessary to fulfil its tasks, and the corresponding duty of financial institutions to provide such data; its right to examine books and records, obtain written or oral explanations from staff.[28]

The ECB Supervisory Board is due to assume its functions in autumn 2014. Each participating member state has one vote.[29] This stands in contrast with EBA's double majority voting system that includes both participating and non-participating Member States. One of the UK's chief concern is that, over time, the ECB Supervisory Board could become the central player, with the EBA mirroring its approach, undermining the double majority system that applies with respect to the EBA.

Non-Eurozone Member States can enter into a close co-operation agreements. They are then required to abide by ECB guidelines and requests. The UK has no intention of entering into such an agreement, and UK financial institutions and subsidiaries of EU financial institutions in the UK will not be subject to ECB supervision but instead continue to be supervised by the UK FCA and PRA. However, UK-authorised branches of credit institutions/large investment firms headquartered in other Member States will be subject to ECB supervision. Examples include Allied Irish, Banca Monte Dei Paschi di Siena, BNP Paribas, Commerzbank, Raiffeisen and SEB.[30] As a result, London as a

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[26] D Howarth and L Quaglia, 'Banking Union as Holy Grail: Rebuilding the Single Market in Financial Services, Stabilizing Europe's Banks and 'Completing' Economic and Monetary Union' 51 JCMS: Journal of Common Market Studies 103, 103; European Council, Completing EMU, 18 October 2012; A Dombret and P S Kenadjian, Introduction, in: A Dombret and P S Kenadjian (eds), *The Bank Recovery and Resolution Directive: Europe's Solution for "Too Big To Fail"* (Berlin/Boston: Walter de Gruyter 2013), p. 1.

[27] 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, Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013.

[28] Art 10 para 1 of proposal COM (2012) 511 final (Council).

[29] http://www.ecb.europa.eu/ssm/orga/html/index.en.html.

[30] http://www.bankofengland.co.uk/pra/Documents/authorisations/banklist1312.pdf

financial centre has a significant stake in the success of the new, ECB-led supervisory regime.

Internal Market Harmonisation under Art 114 TFEU across a group of EU member states

Article 114 TFEU has been relied on more frequently since 2008, including in competition law and state aid law. For example, Regulation 1093/2010 establishing the EBA has Art 114 as legal basis.[31] The UK's central concern about the use of Article 114 TFEU by a group of the EU member countries concerns the integrity of the EU's single market, and effective safeguards for countries not participating in the Eurozone and Banking Union against single market rules being skewed by Eurozone countries in their favour.

The Single Resolution Mechanism

The Commission proposed a Single Resolution Mechanism (SRM) in July 2013 to apply to all banks incorporated in member states participating in the Single Supervisory Mechanism (SSM). The UK will not participate in the SRM and maintains its own resolution mechanism. The latter will however have to meet the requirements of the minimum harmonisation regime under BRRD by the end of 2014.

The SRM is a necessary complement to the SSM. Undesirable incongruence would result if supervision shifted to the supranational level with the creation of the SSM, yet resolution authority remained at the national level.[32] The SRM can also achieve a level playing field and equal treatment of depositors and other creditors across jurisdictions.

Article 114 TFEU may not be an appropriate legal basis (especially for the Common Resolution Fund). The implementation of the SRM may require limited treaty change; however, the discussion on this issue is a moving target. The Bank Recovery and Resolution Directive's scope sets up a unified framework for the recovery and resolution of 'credit institutions' and large investment firms, whether systemically important or not.[33] Implementation at the national level under Art. 3 (1) and (2) BRRD is the task of National Resolution Authorities, which need to be public authorities (unlike deposit insurance schemes under the Deposit Insurance Directive).

Germany disputes that the SRM can be implemented on the basis of Article 114 TFEU alone. The Commission's legal authority to decide on resolution, the fiscal implications of the Single Resolution Mechanism on the budgetary autonomy of Member States while the Single Bank Resolution Fund is being built up, and the right of the Single Resolution Board to request contributions

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[31] Regulation 1093/2010 establishing a European Supervisory Authority (EBA Regulation).
[32] Kern Alexander, 'Bank Resolution and recovery in the EU: enhancing banking union?', *ERA Forum* (2013), p. 11.
[33] Michael Schillig, 'Bank Resolution Regimes in Europe I – Recovery and Resolution Planning, Early Intervention, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2136101, p. 9.

from banks are controversial. The UK shares some of the German concerns, even if the SRM does not affect it directly, given potential spillovers from the SRM to other areas of financial regulation and supervision (especially the use of Article 114 TFEU as a legal basis).

The Legal Service of the Council assessed the suitability of Article 114 TFEU as a legal base for the SRM in a legal opinion dated 11 September 2013.[34] Among others, it evaluated "whether the measures envisaged under the proposal may be applied only to entities established in a limited number of Member States". The Legal Service had no fundamental objection in this respect. We will revert to Art 114 below, when analysing the recent ESMA judgment.

Politically, the creation of the Single Supervisory Mechanism is a precondition for possible direct recapitalizations of banks by the European Stability Mechanism. While the UK does not question the need for a single supervisory mechanism or a single resolution mechanism (including a fiscal backstop), it is concerned that this fundamental reconfiguration of the regulatory and supervisory landscape and the shift of regulatory and supervisory authority to the supranational level might disadvantage financial services firms operating from the UK and could introduce discriminatory treatment against countries, such as the UK, that have no plans to participate in Banking Union. The UK has already overhauled its supervisory framework and adopted a resolution mechanism, faster than the EU and many other EU Member States.

The Single Market and Non-Discriminatory Financial Regulation

In relation to central pieces of financial services regulation, in particular the ongoing review of MiFID, the UK is keen to include stronger safeguards for non-Eurozone countries on market access and non-discrimination. It insists on non-discriminatory access to CCPS, trading venues and benchmarks as a general rule – a major reason behind the UK's challenge to the ECB's location decision in respect of CCPs for bonds of Eurozone member states. The UK has also broader concerns about binding, supranational financial regulation. One example is bonus cap included in CRD IV, another is the restriction on short selling, and most importantly, its challenge to the financial transaction tax. We examine these issues in turn, below.

Financial Transactions Tax[35]

[34] Opinion of the Legal Service, Proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of the Single Resolution Mechanism and a Single Bank Resolution Fund amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council, Doc. 13524/13.

[35] See in particular Financial Transaction Tax: Alive and deadly, House of Lords, Report, 17 December 2013.

Following a failure by the EU27 to agree on a financial transaction tax (FTT) in ECOFIN in 2012, 11 participating member states (Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovenia, Slovakia and Spain) moved ahead under enhanced cooperation. Of the Eurozone's 18 member states, seven chose not to participate in the FTT at this stage (Cyprus, Finland, Ireland, Latvia – Eurozone member from 1 January 2014, Luxembourg, Malta and the Netherlands).

The EU11 FTT proposal issued in February 2013 is based largely on the EU27 proposal dating back to September 2011 (including a 0.1 percent charge for spot transactions and 0.01% for notional derivatives). However, it extends the geographical scope by including the issuance principle and includes a number of anti-avoidance measures. The EU11 aimed to have the tax in place by 1 January 2014, but this is now delayed until at least 2015.

The FTT combines a residence principle with an Issuance Principle to mitigate potential avoidance of the FTT. From the UK's perspective, the broad notion of "deemed establishment" gives the tax extraterritorial effect. This concern about the feasibility and desirability of the residence principle is also shared by some participating Member States, such as Spain, Italy and France, though generally smaller participating member states such as Belgium, Slovenia and Slovakia are keen on the residence principle out of a concern that the issuance principle only would substantially lower FTT tax revenues due to them.

The UK challenged the Council decision authorising enhanced cooperation as regards the FTT on 18 April 2013[36]. Another important EU financial centre, Luxembourg, has also reserved the right to seek legal remedies. The UK is particularly concerned about the use of the enhanced co-operation procedure in relation to tax, and its potential for undermining the unanimity requirement on tax, especially in cases where taxation substantially affects the internal market.[37] It seeks the annulment of the Council's authorisation (Decision 2013/52/EU) under the Enhanced Cooperation Procedure to introduce the FTT (the UK, alongside Luxembourg, Malta and the Czech Republic abstained in the Council). The UK maintains that the FTT does not respect the competences, rights and obligations of Member States which choose not to participate (Art 327 TFEU), imposes non-administrative costs from the implementation of the enhanced cooperation on non-participating Member States (Art 332 TFEU) and interferes with the Single Market

Even though the UK arguably does not object to the FTT as such, it has major reservations about important design features, in particular its impact on non-participating Member States and on the grounds that it exceeds the limits of participating Member States's jurisdiction to tax – a concern about the FTT shared, at least to a degree, by the Council's and the German Bundestag's

[36] Case C-209/13, pending. See Review of the Balance of Competences between the UK and the European Union, Single Market: Financial Services and the Free Movement of Capital: Call for Evidence, October 2013, paras. 4.11-4.16.

[37] Ibid., paras. 6.13-6.24; see also Anzhela Yevgenyeva, The Financial Transaction Tax under the Enhanced Cooperation Procedure (Doctoral thesis, Oxford).

legal services. However, it is doubtful whether there is much traction in the extraterritoriality argument. The argument on the single market appears stronger.

The UK's economic concern is that financial institutions operating from the UK would bear a disproportionate burden of the FTT, even though the UK has decided to stay outside and will not receive any FTT revenues – a concern it has in common with other Member States with financial centres in the EU (Luxembourg, Ireland, Netherlands, Cyprus) and financial centres in third states (Hong Kong, Switzerland, US, Singapore).

The UK advocates important exemptions if the EU11 ultimately implement the FTT, including for pensions, currency, repo transactions. The UK is also keen to reduce the impact of the tax by limiting the types of transactions taxable as far as possible. The FTT should only apply after netting and settlement. Derivatives settlements, repo and securities lending agreements should be regarded as a single transaction. Moreover, transactions between different legal entities in the same group should be exempted. OTC transactions should be subject to differentiated tax rate depending on the duration of the transaction.

The (unsuccessful) challenge by Italy and Spain to the introduction of common EU patent suggests that the CJEU will only consider whether the FTT as designed intrinsically contravenes requirements of the Enhanced Cooperation Procedure and whether participating Member States have complied with the procedural requirements of this process. [38] It is therefore unlikely that the CJEU will consider the substantive design features of the FTT such as the issuance or residence principle at this stage. This challenge by the UK against the FTT is unlikely to succeed. The legal action is widely seen as a tactical move designed to strengthen its negotiation position.

Short-Selling

ESMA has the power to prohibit short selling if necessary to address a threat in exceptional circumstances (Article 28 Short Selling Regulation). [39] Accordingly, ESMA can intervene by way of legally binding acts in Member States financial markets in the event of 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'[40], subject to the requirements set out in Art 1(2) ESMA Regulation.

Art 9(5) ESMA Regulation vests ESMA with the power to temporarily ban financial products and/or practices[41], including short-selling. Insofar as the UK is concerned, Article 33 Regulation overrides sections 131B to 131D of the

[38] Joined Cases C-274/11 and 295/11 *Spain and Italy v Council,* judgment of 16 April 2013.
[39] Regulation 236/2012.
[40] Art 9(5) ESMA Regulation.
[41] The requirements under Art 1(2) or alternatively in case of emergency under Art 18 ESMA Regulation.

Financial Services and Markets Act 200 (c.8), thereby limiting the Prudential Regulatory Authority's (PRA) power to devise rules on short selling.

The Short Selling Regulation (SSR), which entered into force on 1 November 2012, imposes restrictions in four areas: (i) a ban on uncovered sovereign CDS (with the possibility for member states to opt-out under certain conditions) (ii) restrictions on uncovered short sales of shares and sovereign debt, (iii) transparency requirements for net short positions in shares, sovereign debt and, if a competent authority invokes the opt-out in respect of (i), uncovered sovereign CDS and (iv) intervention powers of competent authorities and ESMA.

The UK's concerns are twofold. First, it doubts whether bans on uncovered sovereign CDS and restrictions on short-selling shares and sovereign debt pass cost-benefit analysis. Second, it is also concerned that the conditions for the opt-out are overly restrictive. And more fundamentally, the UK's position is that decisions to ban certain financial products should be taken at Member State, rather than at supranational level.

One way of addressing the UK's concerns would be for the market making exemption to be read broadly. If this exemption applies, market makers are not (i) required to notify competent authorities of significant net short positions in shares and sovereign debt or (ii) to publicly disclose significant net short positions in shares and restrictions on uncovered short positions in shares, sovereign debt and sovereign debt. ESMA Guidelines specify that the exemption applies on an instrument by instrument basis and it is necessary for the financial institution to be member of a trading venue where it conducts some market making activities on a specific financial instrument.

In June 2013, the UK Financial Conduct Authority (FCA) stated that it would not comply with ESMA market making exemption guidelines. Rather, the UK FCA accepted that OTC derivatives fall under the scope of the SSR market making exemption. This deviation from the ESMA Guidelines above means that market making activities in corporate bonds and OTC derivatives are exempt from notification and publication. ESMA and/or the Commission could seek to challenge this implementation by the UK.

Two questions arise in this context. First, does the market making exemption granted by the UK FCA apply throughout the EU in respect of UK financial institutions, or is it territorially limited to the UK? The UK favours a comprehensive, territorially unlimited exemption that benefits financial institutions wherever they may operate in the EU. Second, even if the market making exemption applied throughout the EU, the financial institution itself may also be bound by the ESMA Guidelines. The UK opposes that the market making exemption could reach through the Member States directly to individual financial institutions.

The UK challenged Art 28 of the SSR before the Court of Justice. It entered four pleas in law:

a) breach of the principles relating to the delegation of powers laid down in *Meroni*; [42]
b) breach of the principle established in *Romano*; [43]
c) delegation of powers incompatible with Artt 290 and 291 TFEU;
d) breach of Art 114 TFEU.

The Court, in its judgment of 22 January 2014, rejected all those pleas. On the *Meroni* principle the Court emphasized a number of differences between ESMA and the private law entities in issue in that ECSC case. ESMA is an EU entity created by the EU legislature. It is governed by the ESMA Regulation, and the exercise of the powers under Art 28 of the SSR is circumscribed by various conditions and criteria which limit ESMA's discretion (paras 43-45). ESMA's powers are precisely delineated, and moreover subject to judicial review (para 53). In relation to *Romano*, the Court emphasized the fact that the TFEU, in Artt 263 and 277, expressly permits Union bodies, offices and agencies to adopt acts of general application (para 65). [44]

As regards Artt 290 and 291 TFEU, which do not mention EU bodies, offices or agencies with respect to delegation of powers or implementation of legislation, the Court considered – rightly in our view – that those provisions do not establish a single legal framework under which certain delegated and executive powers may be attributed solely to the Commission. It focused on the fact that the acts of agencies are subject to judicial review; that several agencies are capable of adopting legally binding acts; that ESMA is operating in an area which requires the deployment of specific technical and professional expertise; and that Art 28 should be read in its overall regulatory context (paras 80-86).

The Court was more elaborate on the Art 114 TFEU plea. It did not follow the Opinion of Advocate General Jääskinen, who argued that only Art 352 TFEU could function as the proper legal basis. There were two issues here: whether the conferral on an agency such as ESMA of the power to adopt measures which are legally binding on individuals comes within the concept of "approximation" of laws; and whether that power has as its object the establishment and functioning of the internal market. On the first issue, the Court essentially placed that power within its overall regulatory context, and accepted that it was part of a harmonization effort aimed at ending the current fragmented situation, and avoiding divergent national measures (paras 111-112). On the second point, the Court accepted that the Regulation is intended to prevent the creation of obstacles to the proper functioning of the internal market and the continuing application of divergent measures by Member States. The purpose of the powers provided for in Art 28 was in fact to

[42] Case 9/56 *Meroni v High Authority* [1957-1958] ECR 133.
[43] Case 98/90 *Romano* [1981] ECR 1241.
[44] The express reference to acts of general application in Art 277 is overlooked by N Farage, 'Brussels is trying to bury the City by forcing it to play by warped EU rules', City A.M., 5 February 2014, see http://www.cityam.com/article/1391561167/brussels-trying-bury-city-forcing-it-play-warped-eu-rules.

improve the conditions for the establishment and functioning of the internal market in the financial field (paras 114-116).

We find the Court's reasoning persuasive, though also revealing of an important competence issue bedevilling EMU. It is notable that the UK did *not* seek to argue that the Regulation did not have an internal-market objective as such. Its issue was the powers conferred on ESMA. However, there are important questions about the dividing line between internal market measures and instruments which are essentially aimed at financial stability. In terms of the EU's competences related to financial markets and EMU, financial stability is the (absent) elephant in the room. The complexity of measures adopted after the financial crisis is, in essence, aimed at ensuring such financial stability: at the level of sovereigns (sovereign debt) and of financial institutions (mainly banks). Yet the Treaties are all but silent on the aim of ensuring financial stability. This seems to us a major gap in the constitutional framework governing EMU; a gap which can only be filled by Treaty amendment. [45]

Capital Requirements Directive (CRD IV)

In December 2010, the Basel Committee on Banking Supervision (BCBS) released the Basel III rules with significant changes to the Basel II framework on the level and quality of capital, counterparty credit risk, liquidity and the introduction of a leverage ratio. In July 2011, the Commission proposed the CRD package to replace the previous CRD with a recast Directive and a Regulation. The Capital Requirements Directive IV and the Capital Requirements Regulation (CRR) set out a harmonisation regime on capital, liquidity, leverage and counterparty credit risk, implementing Basel III in the Union. The Directive also goes beyond Basel III to regulate remuneration by providing for a bonus cap on material risk takers employed by credit institutions. Both entered into force on 1 January 2014. The UK has already implemented CRD IV, though not all Member States have done so.[46]

In May 2013, the EBA consulted on the definition of material risk-takers for remuneration purposes which determines to which employees the CRD IV remuneration rules apply. The UK is critical of how broad these criteria are. The EBA also consulted on draft Regulatory Technical Standards (RTS) related to variable remuneration.

The UK has not availed itself of Member States discretion on remuneration. It is an open question whether this opt-out means that UK-based financial institutions are exempted from the bonus cap only in relation to branches in other EU Member States, or also in relation to subsidiaries. A separate question is whether the bonus cap is directly applicable to financial institutions based in the UK.

[45] See further Louis and Lastra (cited above), 134-139.
[46] PRA policy statement (PS7/13).

The UK challenged the legality of the bonus cap ratio provisions in Article 94 CRD[47] and the related remuneration disclosure provisions in Article 450 of the Capital Requirements Regulation.[48] The UK's chief concern is that the bonus cap would have a disproportionate impact on the UK, where the majority of employees in the financial services industry with bonus entitlements affected by CRD IV work. The UK also maintains that the cap, as designed, is unworkable, will not contribute to financial stability, and is likely to be counterproductive.

Markets in Financial Instruments Directive (MiFID) Review

Third country access is a priority for the UK, because the location decisions of financial institutions can depend on the modalities of third country access. If third country access is subject to too many, or burdensome, regulatory hurdles, the attractiveness of London as Europe's leading financial centre could suffer.

A related concern of financial institutions operating from the UK, and consequently of the UK, is that the UK carries sufficient weight in shaping legislative proposals in Brussels. British influence can shape legislative proposals, such as the MiFID II proposal, in particular the Third Country provision.[49]

For example, the Wealth Management Association (WMA) takes the view that

> The third country access restrictions in the AIFMD and original MiFID texts are not only bad for the UK but also for the EU as a whole. They affect not only the USA and other trading partners but also the UK Crown Dependencies with which we have strong historical ties as well as substantial business interests. [50]

Other uncertainties on third country market access relate to[51]

- EMIR Art 25 which prohibits EU bank branches from clearing products in central counterparties (CCP) outside the EU, except and unless the home jurisdiction is assessed as equivalent by Commission and ESMA;
- Credit Rating Agencies rating from Third Countries face hurdles to market access due to uncertainty in the equivalence of the ratings for the calculation of capital requirements

[47] Directive 2013/36/EU (CRD IV).
[48] Regulation EU 575/2013.
[49] BBA answer 11.
[50] Response of the Wealth Management Association to Review of the Balance of Competences between the UK and the European Union, Single Market: Financial Services and the Free Movement of Capital: Call for Evidence, 16 January 2014.
[51] Response of the British Bankers' Association to Review of the Balance of Competences between the UK and the European Union, Single Market: Financial Services and the Free Movement of Capital: Call for Evidence, 16 January 2014.

- Current proposals for Financial Benchmarks Regulation with respect to the Third Country provision effects the prohibition of financial products such as the S&P 500 Tracker.

Questions 12-13: role of the ECB

In the UK central banking culture, price stability is seen as intimately linked to financial and monetary stability. Accordingly, the Bank of England pursues two core purposes in its work, monetary and financial stability. The Bank of England Act 1998, as amended by the Financial Services Act 2012 and which entered into force on 1 April 2013, provides relevantly in sec 2A(1) that '[a]n objective of the Bank shall be to protect and enhance the stability of the financial system of the United Kingdom.'

The Bank of England has had an important financial stability division since 1998, led by one of the two Deputy Governors. One of the deputy governors, who reports directly to the Governor, is responsible for Financial Stability, the other for Monetary Policy. The Financial Services Act 2012 created the post of a third Deputy Governor with responsibility for prudential regulation. This Deputy Governor is at the same time the Chief Executive of the Prudential Regulation Authority, PRU. It also established an independent Financial Policy Committee (FPC), a new prudential regulator – the PRU - as a subsidiary of the Bank, and vested new responsibilities for the supervision of financial market infrastructure in the Bank of England.

Institutionally, the ECB elevated the status of financial stability in February 2010 with the creation of a Directorate General of Financial Stability, replacing the former Directorate of Financial Stability. However, neither the TFEU nor the ECB Statute refers expressly to 'financial stability' as an objective, or task of the ECB. That said, fundamental financial instability is likely – at least in the medium run - to undermine price stability, the ECB's primary objective under Article 127 (1) TFEU, and put at risk the support that the ECB ought to provide to the general economic policies of the Union. The ECB divides its functions into (i) basic tasks (monetary policy, foreign exchange operations, management of reserves and the operation of the payment system) and (ii) further tasks (issuance of banknotes, collection of statistics, financial stability and supervision and international and European cooperation).[52] In terms of the mandate and the governing instruments, financial stability thus appears to play a lesser role.

The legal basis for the ECB Regulation (SSM) is Article 127(6) TFEU. Under this provision, the Council acts by means of Regulations, and the European Parliament and the ECB are only consulted. In the Council, unanimity is required.

<u>Scope of Article 127(6) TFEU</u>

[52] http://www.ecb.europa.eu/ecb/tasks/html/index.en.html

Article 127(6) permits the conferral on the ECB of *specific* tasks concerning *prudential* supervision. Arguably, it prevents conferral of all aspects of prudential supervision to the ECB. The conferral needs to be limited in scope. One important question is whether the limited supervisory powers conferred on the ECB are discretionary à la *Meroni.*

The need for certain adjustments to the EBA Regulation, a matter for co-decision by the European Parliament and the Council, has given the European Parliament leverage over the content of the ECB Regulation.[53]

<u>Constraints in relation to Member States outside the euro area</u>

A central concern for non-participating countries is that 'the emergence of the ECB as a powerful coordinating force in supervision could have disturbing implications for the EBA in the longer term. Rather than being a crucial single market cohesion mechanism, the EBA could itself become marginalised.'[54] The emergence of EU17 national authorities as a voting bloc was an acute concern to the UK, given that 'the EU17 national authorities will increasingly coalesce around a common position as the ECB puts its stamp on Euro Area supervisory practices, procedures, policies and philosophies, since this growing uniformity can be expected to spill over into regulatory thinking as well.'[55]

The double-majority voting system in the EBA represents a compromise between Eurozone and non-Eurozone EU member states. It seeks to ensure equality of treatment within the SSM between participating and non-participating member states by addressing the risk that member states of the SSM vote en bloc, and consequently, that participating states can outvote those outside.

Accordingly, 'any decision [requires] majority support among those participating in the SSM (including non-members of the Euro Area that have concluded close co-operation arrangements with it) and those not participating. Decisions under art.17 of Regulation 1093/2010 concerning breaches of Union law or under its art.19 concerning the settlement of disagreements are first to be examined by an independent panel of voting members of the Board of Supervisors.[56] The decisions proposed by the panel to the Board of Supervisors are to be adopted by a simple majority of those members of the Board from Member States participating in the SSM, and a simple majority of those from non-participating Member States.'[57]

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[53] VSG Babis and E Ferran, 'The European Single Supervisory Mechanism'(2013) 13(2) Journal of Corporate Law Studies 255.
[54] Ibid.
[55] Ibid.
[56] Panels are to be convoked by the Board of Supervisors consisting of the chair of the Board and six other members who do not have any conflicts of interest in the matters in issue: Regulation 1093/2010, as amended, Art 41(1a) and (2).
[57] Sir Alan Dashwood QC, 'The United Kingdom in a re-formed European Union' (2013) 38(6) European Law Review 737, 748.

The rationale of this voting system, as stated in Recital 6 of the Preamble of the Regulation 1093/2010, is

> ‘to ensure that interests of all Member States are adequately taken into account and to allow for the proper functioning of the EBA with a view to maintaining and deepening the internal market in the field of financial services’.

Once the number of Member States not participating falls to four, a simple majority on the Board of Supervisors suffices, provided at least one of the non-participating member states votes in favour (Art 44(1)(2)(4)). At that stage, the Commission will review and report to the EU Parliament, the Council and the European Council.

Non-Eurozone states have secured safeguards against states participating in the SSM reaching decisions on their own. The conclusions of the October 2012 European Council meeting called for ‘the equitable treatment and representation of both euro and non-euro area Member States participating in the SSM’. Nevertheless, according to Babis and Ferran, in the long run the only satisfactory solution for non-participating states such as the UK is an amendment to Art 127(6) TFEU.[58] Whether it is possible to opt-in only to participate in the SSM, but not the SRM – including contributing to the Single Resolution Fund – is an open question (though one that is not of direct relevance to the UK given that it is committed not to join the SSM in the first place).

If a non-participating Member State disagrees with the ECB Governing Council’s objection, decision or amendments, it can demand that the Governing Council give a reasoned opinion.[59] The safeguard shall only be invoked in ‘duly justified, exceptional cases’.[60] The Member State can notify the ECB ‘that it will be not bound by any amendments to the Supervisory Board’s decision made by the Governing Council’.[61] In turn, if the non-participating Member State disagrees with the Supervisory Board, it can ask the Governing Council to decide the dispute. Otherwise, as a last resort, the Member State can terminate the close cooperation agreement and, as a result, would no longer be bound by the relevant decision.[62] ‘Finally, non-euro Member States have equal status to Euro Area Member States with regard to a range of issues in the ECB Regulation, including accountability of the ECB and the Supervisory Board.’[63]

[58] Recital 85 ECB Regulation, referring to the Commission Communication of 28 November 2012 on a Blueprint for a deep and genuine economic and monetary union (COM(2012) 777 final).
[59] Art 7(7) and Art 26(8) ECB Regulation. The ECB Regulation envisages that the Governing Council should invite the representatives from non-euro participating Member States when it contemplates to object to a draft decision prepared by the Supervisory Board as stipulated in Recital 72 ECB Regulation.
[60] Recital 43 ECB Regulation.
[61] Babis and Ferran (cited above), 274.
[62] Art 26(8) and Art 7(8) ECB Regulation.
[63] Babis and Ferran (cited above), 274-275.

Under Art 44 of Regulation (EU) 1093/2010), EBA decisions on binding technical standards are subject to qualified majority voting, whereas supervisory decisions are subject to simple majority voting in the Board of Supervisors. The EBA Amendment Regulation included a safeguard for non-participating states in respect of regulatory decisions. These must include, in addition, a simple majority from both participating Member States and non-participating Member States.[64] The downside of this mechanism is that non-participating member states could potentially veto rule-making for the Banking Union as a whole.

The ECB is also called upon to develop a "supervisory manual" for national authorities under its remit.[65] As Babis and Ferran note, 'the ECB's guidelines, recommendations and decisions--and, consequently, the ECB's manual--should comply with the EBA's supervisory handbook'. Conversely, the EBA is expected to 'develop a Single Supervisory Handbook for the whole EU, attributed to the EBA, recognises the importance that key chapters of the manual are truly common across the Single Market'.[66]

There is controversy about whether the ECB's independence conflicts with the EBA's power to impose binding decisions on competent authorities (including the ECB). All competent authorities, including the ECB, are required to follow the EBA's lead.

A further safeguard against regulatory decisions tilted towards the interests of those member states participating in the SRM is that the European Commission could intervene by refusing to endorse or by amending an EBA draft standard because 'the Union's interests so require'.[67]

Question 14: role of the Court of Justice

The UK is comfortable with the idea that central banks, from time to time, engage in open market purchases of sovereign debt to support the central bank's monetary and financial stability objectives. Indeed, the Bank of England embarked on its first major wave of quantitative easing from March 2009-November 2009, with purchases of up to £200 billion in UK government debt[68], a year ahead of the ECB's (much less ambitious) Securities Market Programme (SMP) which started in May 2010 and its successor, Outright

[64] EBA Amendment Regulation, Art 1(7) amending Regulation (EU) 1093/2010 Art 44.
[65] Art 6(5) ECB Regulation.
[66] A Enria, 'Implications of the Single Supervisory Mechanism on the European System of Financial Supervision: The EBA Perspective', Intervention at the European Commission public hearing on financial supervision in the EU, Brussels, 24 May 2013.
[67] Arts 10 and 15 Regulation (EU) 1093/2010.
[68] Bank of England, The United Kingdom's quantitative easing policy: design, operation and impact, Quarterly Bulletin, 2011, Q3.

Monetary Transactions (OMT) that commenced only in August 2012.[69] Neither the SMP nor the OMT amounts to quantitative easing as the ECB fully sterilises asset purchases. If anything, the criticism from the UK, from the official as well as the private sector, was that the ECB did too little, too late, and could have counteracted the Eurozone crisis headwinds by moving towards full-scale quantitative easing when the Greek debt crisis first erupted.

In addition, the UK does not have objections in principle to the ECB acquiring a more important role in financial supervision, including macroprudential regulation, provided its position as a non-member of the Eurozone does not lead, directly or indirectly, to unequal treatment in the single market.

In one important respect, the UK has been critical of ECB policy. The UK challenged the ECB's location decision in respect of central clearing counterparties (CCPs).[70] Under a standard adopted by the ECB, the Eurosystem is to use only those CCPs that meet ECB standards.[71] Systems that settle euro-denominated payment transactions above a threshold (€5 billion per day or more or a market share larger than 0.2 percent) must settle in central bank money, must be located in one of the Member States of the Eurozone and managerial and operational control must be exercised from within a Eurozone Member States.

The UK maintains that the ECB lacked competence to adopt this standard of Eurozone clearing at all, or in any event, it could have only been included as part of a regulation. Furthermore, it contends that the policy restricts the free movement of capital and the right of establishment, restricts and distorts competition in the Single Market and discriminates against CCPs by nationality, to the disadvantage of CCPs in the UK.

The challenge of the location decision apart, it is highly unlikely, in view of the UK's policy preferences described above, for the UK to challenge other ECB decisions, especially on monetary policy. Eurozone member states would likely regard such challenges as an interference in the Eurozone's internal monetary arrangements. Viewed from that perspective, it would be odd for a non-Eurozone state to seek to challenge monetary or financial stability decisions of the Eurozone's central bank.

In principle, the decisions and actions of the European System of Central Banks are subject to judicial review.[72] The possibility of judicial review could be regarded as an important check on the ECB, given that it is not embedded in a (national) system of checks and balances on the model of other CBs and

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[69] ECB, Press Release, 6 September 2012, Technical Features of Outright Monetary Transactions.

[70] See Cases T-496/11, T-45/12 and T-93/13 *United Kingdom v ECB*, pending.

[71] ECB standards for use of CCPs in Eurosystem foreign reserve management operations, November 2011.

[72] R Smits, *The European Central Bank : Institutional Aspects*, *International Banking and Finance Law Series* (The Hague ; Boston: Kluwer Law International, 1997), p. 106; P Craig, 'EMU, the European Central Bank and Judicial Review' in P R Beaumont and N Walker (eds), *Legal framework of the single European currency* (Hart Pub. 1999); P Brentford, 'Constitutional Aspects of the Independence of the European Central Bank' 47 ICLQ 75.

given that it enjoys the highest degree of independence of any major central bank in the world. In the absence of effective political accountability mechanisms, judicial review could provide a measure of accountability.

Even though several commentators regard judicial review of central bank conduct as natural in a rule-of-law-based community such as the EU[73], in international comparison this possibility is unusual. Central banks have traditionally operated in an environment in which litigation is a virtual unknown, and where the exact rules and competences were less important than the standing of the central bank and the weight of its advice.[74]

As a general rule, internationally there is no review of monetary policy decisions, though judicial review may be provided for in relation to central banks acting in a supervisory capacity. The question of when judicial review of ECB acts (and omissions) is possible, is likely to become more important as the ECB takes on its new supervisory responsibilities under the SSM.

The rationale for limiting (or entirely precluding) judicial review in respect of monetary policy decisions is the tension between central bank independence and judicial review, and doubts about the justiciability of monetary policy and holder of institutional competence (courts vs. central banks). In the UK, the possibility of judicial review in respect of monetary policy decisions of the Bank of England is in practice more limited than with respect to supervisory decisions (now the remit of the new Prudential Regulation Authority). The obstacles to liability of the Bank of England under English law are high. The Bank enjoys wide statutory immunity from liability in damages, which is limited to cases of bad faith (Sec 1(4) Banking Act 1987, Schedule 1, S. 17(1) of the Financial Services and Market Bill). The English courts have been very reluctant to impose a duty of care upon regulators in respect of economic loss. Misfeasance in public office, an intentional tort involving bad faith, is the only option, or EU law.

In *Three Rivers v Bank of England*, the House of Lords considered the question of state liability for inadequate supervision.[75] BCCI depositors initiated legal action on the grounds that the BoE had wrongfully granted a license to BCCI and had failed to adequately supervise the bank which caused loss to depositors. The depositors also alleged that the Bank of England was liable in damages for having breached its supervisory obligations under EU law. Even though the House of Lords allowed a misfeasance action to proceed against the Bank of England, the action ultimately failed.

The Privy Council in *Yuen Kun Yeu v Attorney General of Hong Kong* held that the financial regulator does not owe any duty of care to depositors and no

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[73] Smits (cited above).
[74] See also Ralph J. Mehnert-Meland, *Central Bank to the European Union : European Monetary Institute, European System of Central Banks, European Central Bank : Structures, Tasks, and Functions* (London; Boston: Kluwer Law International, 1995), 50-51.
[75] *Three Rivers DC v Bank of England (No.3)* [2001] UKHL 16.

tortious liability can be established for the failure of taking reasonable steps to prevent loss to depositors.[76]

By contrast, judicial review of the ECB could extend, again in principle, to monetary policy decisions and open market operations – which does not accord with UK's tradition. Unlike many national central banks such as the BoE, the ECB does not enjoy statutory (treaty) immunity from suit, in either national courts or before the CJEU.[77]

There is potentially broader scope for challenging the acts and omission of the ECB under Article 35.1 of its Statute, including the new ECB Supervisory Board: "The acts or omissions of the ECB shall be open to review or interpretation by the Court of Justice of the European Union in the cases and under the conditions laid down in the Treaty on the Functioning of the European Union." Judicial review of the ECB could thus extend, again in principle, to monetary policy decisions and open market operations.

The reach of judicial review of ECB conduct is however limited, due to two principal factors. First, the CJEU can only review the legality of binding ECB measures. Second, and even more importantly, standing is circumscribed. Those most likely to seek to challenge monetary policy and prudential decisions – individuals affected by the measures or opposed to such measures for reasons of principle – are unlikely to enjoy standing. As non-privileged applicants, they enjoy standing only under the (restrictive) conditions laid down in Art.263(4) TFEU. As a rule, they are unlikely to meet the standing requirements for actions for annulment against ECB decisions in the field of monetary policy or supervision.

By contrast, Member states such as the UK, as privileged applicants for actions of annulment under Article 263 TFEU, automatically satisfy the standing requirement. However, the Governing Council's monetary policy decisions are not intended to produce legal effects, and for that reason, actions in annulment by member states are unlikely to succeed. Only ECB decisions but not guidelines are reviewable acts (Article 12 ECB Statute, Article 289 TFEU). Matters could be different with respect to supervisory decisions in relation to particular banks. Attempts to hold the ECB to account in this area are more likely.

Concluding remarks

It is not necessary in these concluding remarks to sum up the range of issues connected to the UK's position towards EMU and financial markets governance. We would however like to reiterate two general concerns.

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[76] [1988] A.C. 175; see *R. (on the application of SRM Global Master Fund LP) v Treasury Commissioner* [2009] EWHC 227 (Admin), para. 141 (extending the reasoning to the Financial Services Authority).

[77] See further P Athanassiou, Financial Sector Supervisor's Accountability, A European Perspective, ECB Legal Working Paper Series, No. 12, August 2011.

First, the use of non-EU instruments such as the ESM, the Fiscal Compact, and others which are potentially to follow, seems to us difficult to sustain in the middle to long term. The awkward legal relationship with EU law is unsatisfactory, and contrary to constitutional principle. The latter are not just concerned with abstract concepts. As the EU aims to promote greater financial stability, the use of intergovernmental mechanisms and institutions risks eroding the stability of the EU legal system. The *Pringle* judgment is, with greatest respect, a flashing indicator of such erosion.

Second, the UK's major concern is to safeguard the internal market and its financial services industry. The dividing lines between internal market competences, EU economic policy coordination, and monetary policy are difficult to draw. This is in our view particularly so because the founding Treaties lack specific provisions expressly enabling the EU to safeguard financial stability.

Both these concerns point in one direction: the need for significant Treaty amendment.