

8. Governing finance in Europe: discussion and conclusion

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8.1 INTRODUCTION

In this book we have raised the question of whether and why the governance of financial markets has led to a centralisation, decentralisation or fragmentation of regulatory structures in Europe. In the theory chapter we developed hypothetical answers to this question from four research perspectives: European legislation in the context of international agreements; international competition between regulatory powers; the interaction between private self-regulation and public regulation; and technological (digital) innovation of financial instruments.

In this concluding chapter, we first identify whether the findings of the empirical chapters confirm our hypotheses, and if they disconfirm them, what conclusions need to be drawn on our theoretical explanations. We further draw links between the arguments in the individual chapters and identify whether they reinforce, complement or contradict each other.

Second, we go beyond the strict scope of our present theoretically guided empirical investigation and raise questions concerning the political and legal accountability of the regulatory structures we have found. How do they matter in terms of the effects of regulations and endeavours to hold regulators accountable for their decisions? Since accountability questions mostly arise if they are linked to the policy effects of regulation, we consider these two factors together when formulating preliminary arguments regarding political and legal accountability and the effects of financial regulation in Europe. A systematic empirical investigation of these preliminary findings will constitute an important avenue for future research on this topic.

8.2 GENERAL INSIGHTS AND FINDINGS IN THE CHAPTERS

From the *vertical international research perspective*, that is, European financial market legislation in the context of international agreements, we started from the fact that there is pressure which derives from international agreements and regulatory bodies on regional regulators to harmonise financial regulation. In the EU, this pressure translates into a complex political process at the supranational and Member State levels. Since national economic, political, institutional, legal and social factors vary, the outcomes in Europe's regulatory structure and policy substance are not necessarily uniform and do not automatically lead to a centralisation of rule-making.

In their chapter on the *MiFiD II regulation of high frequency trading*, Jan Karremans and Magnus G. Schoeller found that under the indirect influence of the G20 agenda strong attempts were made by the Commission (*H5*), and also by the EP, to advance a centralisation of HFT regulation. Hence, when also taking into consideration the EP, centralisation endeavours originate from *two* actors at the EU level and not, as we anticipated, only from the Commission. Moreover, the authors show that the EU legislative initiatives were partly built on the corresponding pre-existing national regulation of HFT in Germany. While they find that rule-making at the European level constitutes an instance of centralisation led by the Commission and the EP, thus formally uploading regulatory competences to the EU level, this centralisation is challenged in the course of implementation when the centrally defined technical standards are supervised in Member States using different practices and surveillance structures (*H2*). Hence, we find a centralisation of rule-making at the European level but decentralised modes of implementation at the national level.

From the same vertical international perspective, Fabio Bulfone and Agnieszka Smoleńska focus on *central counterparty (CCP) clearing* in the context of the Capital Markets Union (CMU).¹ They show that the Commission indeed seized the opportunity of international pressure resulting from the G20 to initiate centralising legislation (*H5*). However, they also show that this centralising attempt in favour of the Commission and ESMA at the supranational level was challenged by claims from the ECB, which sought to gain supervisory power over the market. This attempt was successfully opposed by the EP, which, given that it has less power to hold the ECB accountable, was in favour of centralising power in the ESMA.

Supporting Karremans' and Schoeller's findings in Chapter 2, Bulfone and Smoleńska also find that a centralisation of rule-making and a decentralisation of regulatory structures at the implementation level exist alongside each other. Regarding rule-making at the supranational level, they also show that given *de*

facto consensus decision-making² it was only after the UK's exit decision (*H6* and *H7*) that preferences among the larger countries converged and centralisation initiatives with respect to the regulation of third-country CCPs became successful. By contrast, regarding the internal regulation of CCPs, Member States' competing economic interests in taking over part of the UK CCPs' functions in the internal market prevented moves to centralise intra-EU CCPs (that is, entities authorised in one of the Member States), with Germany acting as a veto player (*H5*), being motivated by internal competition for a higher CCP market share after Brexit. As in Chapter 2 on HFT, the authors find that the supervisory structures at the implementation level in Member States vary to a great extent as a function of pre-existing institutional structures. Moreover, the pressure of internal competition for CCP market shares reinforced differences among Member States. As the authors find a decentralisation of implementing structures in the internal market, they question our hypothesis (*H6*) that competition between different regional regulatory powers, in this case the EU and the UK, strengthens internal coherence within one regional regulatory power, as it is argued by Heikki Marjosola in Chapter 5 on the regulatory competition between EU and the US (see below).

The chapter on the *choice of legal instruments* from the vertical international perspective by Magnus Strand addresses the hypothesis that an increasing use of regulations (rather than directives) implies more centralised control. Strand tests this claim with regard to the regulation of financial instruments under MiFID II. In his empirical analysis he does not find such an impact, thereby disconfirming *H4.1* and *H4.2*. Strand takes an important further analytical step by inquiring into rules that are specifically directed at EU agencies. He finds more 'high density' regulation if rules are addressed to regulatory authorities such as ESMA. This can be explained by the legislator's wish to control the EU agencies. Moreover, Strand also analyses non-legislative acts (delegated acts) directed at other institutional actors such as national authorities. He shows that non-legislative acts adopted on the basis of MiFID and MiFIR created an extensive set of rules centralising financial governance when addressing administrations at both the European and national levels. As a result, we learn that if directives – which give more latitude to implementation through transposition into national legislation – are used, this latitude may subsequently be restricted through delegated legislation.

Here, we find a certain contradiction with the empirical findings in both Chapters 2 and 3. While formal regulatory decisions aim at centralisation and harmonisation, their implementation by Member States is characterised by decentralisation, or even fragmentation, in regulatory practices (i.e. a differential application of formal rules by the Member States). We may explain these contradictory findings by distinguishing time periods. The pattern of centralised formal rules and decentralised implementation may emerge in

a first instance (t1). In a second instance (t2), delegated legislation governing the implementation phase counters decentralising tendencies and leads back to more centralised implementation. Moreover, as Carl Fredrik Bergström³ emphasises, in a longer time perspective fragmented or decentralised regulatory structures in implementation tend to be levelled out by court rulings seeking to establish similar regulatory practices and structures.

From the *horizontal international perspective*, we ask whether regulatory competition between regulatory powers leads to a centralisation of regulatory structure within the EU as a regulatory power. Heikki Marjosola argues that the *regulatory rivalry between the EU and the US in the field of OTC regulation*, specifically the regulation of CCPs, leads to a fragmentation of the regulatory structure internationally and in consequence to regulatory arbitrage by the regulated. Regulatory competition and resulting regulatory arbitrage by the industry may in turn lead to an internal centralisation of regulatory structures within one regulatory power seeking to better coordinate its policies in view of external competition (H6).

Moreover, in order to reduce regulatory arbitrage, regulatory powers may refrain from imposing their own regulation on the rest of the world (extraterritorial application) or seek to coordinate their regulatory prescriptions (H7) if one party takes the lead in this coordination by using strategies of regulatory equivalence or mutual recognition. Such efforts will lead to a gradual convergence of regulatory prescriptions. Marjosola finds that progress towards a deference-based recognition regime has been slow in bargaining on an agreement between the US and the EU, the negotiations being complicated by the Brexit decision and the issue of how to regulate third-country CCPs. The EU's EMIR legislation in response strengthened the powers of the ESMA, the central EU administrative authority, leading to a centralisation within the EU regarding the regulation of third-country CCPs operating in the EU, confirming our hypothesis H6. However, as Bulfone and Smoleńska analysed in Chapter 3, this only holds for the regulation of third-country (extra-EU) CCPs providing services in the EU market, but not for that of CCPs already established in one of the Member States (and therefore supervised by a national competent authority – see above).

From the *public–private interaction perspective* Johannes Karremans and Adrienne Héritier ask whether the *self-regulation of financial services* by private actors and subsequent *public–private co-regulation* lead to a centralisation or fragmentation of regulatory structure in the EU. Self-regulation rules have frequently emerged in new markets, with public actors subsequently intervening step by step, leading to a form of hybrid regulatory governance structure (H8). While the initial forms of self-regulation may have given rise to a fragmented structure, one would expect an emergence of more centralising features with increasing intervention by public actors. The two cases analysed

in this chapter, the self-regulation of OTC derivatives by the International Swaps and Derivatives Association (ISDA) and the Alternative Investment Market (AIM) of the London Stock Exchange (LSE), tell the story of new European rules entering two spheres of the financial markets that were previously almost entirely self-regulated and that shared similar patterns of public regulatory intervention. In both cases, in fact, the European public regulator intervened by adding new rules that are valid for the EU to the existing regime, thus leading to a partial centralisation of regulatory structure.

In both cases we see that failures of private self-regulatory regimes to tackle systemic risk and excessive rent-seeking prompted intervention (*H8*). While the private regulatory regimes – ISDA’s ‘master agreement’ and the regime governed by ‘Nomads’ in the AIM – remain in place, financial transactions in these markets are now directly subject to European regulatory requirements. However, as the empirical findings in the chapter on MiFID II show, surveillance structures vary across Member States during the implementation phase of a central rule. Thus, also under hybrid regulation, implementation by private actors may differ and lead to a fragmented regulatory structure.

While the general hypothesis about private self-regulation prompting public regulation, given the risks of micro fraud and system instability, is confirmed, our arguments regarding the causes of the emergence of regulatory regimes (*H8.1* and *H8.2*) are only partly confirmed. On the one hand, the idea that private regimes will attract new members and that these will adapt to the existing regulatory structure (*H8.2*) is confirmed in both cases: ISDA has attracted a rapidly rising number of participants in the case of OTC derivatives, and AIM gathered companies under the LSE private regime. On the other hand, our hypothesis that private regulatory regimes emerge as a result of innovation in financial instruments (*H8.1*) only finds confirmation in ISDA’s rise as a private authority linked to the growing complexity and technological progress in derivative trading (also see Chapter 6 on technological innovation in financial transactions and its impact on regulatory regimes). By contrast, the case of AIM, which was created by the LSE in order to avoid the heavy regulation of initial public offerings (IPOs), disconfirms our hypothesis. Indeed, this reaction to strengthened regulation is well-known. The regulated seek to eschew regulation by developing a slightly different financial product which does not correspond to the prescriptions of existing regulation. Hence, the emergence of AIM cannot be traced back to an independent rise of new financial instruments.

As a consequence, our theoretical argument on the rise of self-regulation needs to be refined by including private actors having the goal of avoiding existing regulation. An additional general insight deriving from the empirical findings is that private actors are not *per se* against a centralisation of rule-making. On the contrary, especially if they operate transnationally, they

tend to be in favour of homogenous rules across different jurisdictions. At the same time, private actors may be very keen to shelter particular segments of the market from public regulation.

From the *technological innovation perspective*, we ask, given the rapid technological digital innovations of ever more financial products, what the challenges are for regulators in governing these new instruments. To what extent do they effect (de)centralisation or fragmentation in the EU's regulatory structure? Agnieszka Smoleńska, Joseph Ganderson and Adrienne Héritier (Chapter 7) argue that the type and level of uncertainty about risks linked to a new financial product or business model are crucial factors influencing the reaction of regulators. They distinguish between substantive, legal and cross-sectoral uncertainty and also (un)certainty regarding compliance with regulatory prescriptions. The authors show that substantive uncertainty regarding the nature of new financial instruments induces regulators to cooperate with the industry when developing bespoke regulatory requirements, engaging in 'sandboxing' or creating innovation hubs. This leads to fragmentation in a first instance, which in turn is limited by seeking regulatory convergence (H10). In the case of legal uncertainty, regulators seek to fit the new risks into pre-existing legal rules (H11), which also helps them reduce uncertainty in the case of cross-sectoral risks regarding the provision of public goods (H12). This can lead to fragmentation where authorities at the centralised and decentralised levels pursue different strategies in the face of uncertainty. In the case of the application of regtech, which presupposes that the regulator and the regulated market actors have at their disposal the necessary resources, the regulator has no uncertainty regarding real-time financial transactions, which, if the relevant rules are detailed and strict, leads to a centralisation of regulation (H13). Empirical cases demonstrate the plausibility of these claims. However, it further emerges that an additional factor may drive centralisation, that is, the collection and processing of large quantities of data on financial transactions in the course of trans-border data conciliation by the competent central authority (here, ESMA). The role of the regulatory agency as a data gatekeeper reinforces a centralisation of regulation, even if formal regulatory structures remain decentralised.

In summary, the theoretically guided empirical insights in the five empirical chapters seen together show that the formulation of rules has led to a partial centralisation of regulatory structures in Europe due to pressure from international agreements, regulatory competition between regulatory powers, an increasing influence of public actors on private self-regulation and digital technological innovations in the use of financial instruments and regulation. At the same time, at the level of the implementation of centralising rules by Member States or private actors, decentralising or even fragmenting forces deriving from diverse economic interests and institutional traditions among

the Member States impact on regulatory structures. Technological innovation (fintech) and subsequent self-regulation tend to prompt public regulation with the intention of harmonising rules in a first stage, while decentralised implementation at the national level remains (see above). Only in a second stage may divergences in the implementation of rules become subject to renewed attempts at harmonisation through delegated technical legislation (Chapter 4) and court rulings (Chapter 6). Centralising legislation (Chapters 2 and 3), with its demands of massive amounts of data being provided by financial firms in order to allow for transparency, in turn reinforces technological innovation by fintech in the form of regtech (Chapter 6). Regtech, if widely applied, finally leads to a centralisation of regulatory structures, given the scope for real-time control of rule compliance.

The findings of partial centralisation of regulatory structures in rule-making in almost all the chapters, albeit attenuated by decentralisation or fragmentation during implementation, gives rise to the question of how these regulatory structures can be subject to political accountability mechanisms. European regulations imply a loss of decision-making power of national parliaments and hence less democratic accountability at the national level. In future research steps, we will therefore turn to the question of *political and legal accountability*.

8.3 POLITICAL AND LEGAL ACCOUNTABILITY IN VIEW OF REGULATORY EFFECTS

In explaining the regulatory structures resulting from European regulation of financial markets under MiFID II and CMU, we predominantly found centralised regulatory structures in rule-formulation but decentralised or fragmented regulatory structures in the implementation of these rules. Moving to questions on effects and accountability, we ask how the regulatory decisions produced under these structures are held accountable. This question becomes most relevant when it is linked to regulatory effects which are salient in public attention, that is, causing public discontent and therefore giving rise to a wish to hold regulators accountable. In further research steps going beyond the scope of this book, we will therefore analyse *policy effects and accountability mechanisms in their interlinkedness*.

To start with a brief empirical illustration of institutional accountability channels identified in this volume, we have found that technical standards are defined at the EU level (by national authorities represented in ESMA) while market supervision falls under the responsibility of national authorities. This implies that political accountability runs through two channels (and possibly a third one). The first channel is the national level: national financial authorities are responsible to their governments and parliaments. The second channel

is the European level: if technical standards are found to be deficient in their effects, in principle the European Parliament should call the Commission to explain and eventually justify the actions of ESMA. The third channel of accountability is the way ESMA functions. In addition to being a supranational agency with its own permanent staff, ESMA also involves a monthly meeting of national financial authorities. In these meetings, national authorities discuss their differences and try to find common solutions for market supervision. These meetings therefore have a tempering effect on the de-centralisation patterns identified in the empirical chapters in this volume. Moreover, the meetings are a form of horizontal accountability mechanism: the national authorities monitor each other.

From this first illustrative mapping of possible political and administrative accountability channels under MiFiD II and CMU, a range of conceptual questions emerge regarding the effects/accountability link. They will be outlined here and tackled in future research.

A first challenge is to determine the *scope and the nature of the effects* of regulation which is subject to accountability mechanisms. Financial market transactions in their functioning and their regulation are not easily accessible to the wider public and the target groups of regulation. In other words, financial market regulation is an informationally secluded policy area. This does not mean that financial regulation is intentionally secluded,⁴ but instead that it is hard to grasp it in its technological and economic complexity and in view of the worldwide interlinkedness of financial transactions, market players and regulators' decisions.⁵ In consequence, future research will need to limit its analysis to clearly restricted measures (such as the provisions under MiFiD II and CMU) that are accessible to a causal explanation in order to analyse their effects on market actors and investors. For such cases, one can investigate institutional accountability mechanisms that are available to the target groups of regulation and the public at large in order for them to contest these effects. Furthermore, the difference that the use of accountability mechanisms makes regarding the regulatory effects in question will need to be analysed.

With regard to the *concept of accountability*, a second challenge is to define accountability mechanisms. These have proliferated in recent decades, as is described in the large literature on political and legal accountability mechanisms in their various forms (e.g. the *Oxford Handbook on Public Accountability*, Bovens and Schillemans 2014).⁶ In political science, political accountability is often defined as a mechanism with which, after the delegation of a task by a political actor (the 'principal') to an executive actor (the 'agent'), the execution of this task can be monitored by the principal if it has sufficient information on the quality of task performance (principal-agent approach). If the execution is considered to be unsatisfactory, the principal must be able to sanction the malperformance by various means, such as imposing fines or

withdrawing the delegation of the task (i.e. dismissing the agent). These three elements – that is, task delegation, monitoring of task performance and sanctions in the case of non-performance – form arguably one of the most extensive conceptualisations of the mechanism realising political accountability (e.g. Bovens and Schillemans 2014).⁷

Analytical distinctions in the use of accountability mechanisms may be helpful to analyse the link between regulatory effects and accountability. One distinction reaching back to the distinction between procedural law and substantive law (Jeschek et al. 2017) refers to the procedural and substantive accountability provided by courts (see for instance most recently Dawson and Maricut-Akbik 2019). In political science analysis, this distinction between substantive and procedural accountability is relevant and raises the question of how different existing types of accountability mechanisms play out when used by target groups of regulation which are dissatisfied with the effects of financial regulation. Substantive accountability mechanisms in this context would imply a possibility for actors affected by regulatory decisions to question the very substance of the regulation and possibly obtain a modification of the substance, beyond being (only) based on the procedural correctness of the underlying decision process.

Another relevant question linked to regulatory effects and accountability mechanisms and deriving from this discussion asks about the *type of instrument* used in regulation and its implications for political and legal accountability. Pistor, referring to the dilemma of the regulator, emphasises that soft law is more elusive of accountability requests. If rules are rigid and precise, the public can more easily apply political accountability mechanisms, but rigid rules are difficult for the regulator because in cases of contingencies or crisis a flexibility of rules may be needed to deal with a financial market problem. In turn this means less political accountability to the public (Pistor 2019); see also Dawson and Maricut-Akbik (2019).

Further analytical perspectives from which to examine the effects–accountability link may be gained from the distinction between legal and political *ex ante* and *ex post* accountability mechanisms. Bergström (2019) underlines that the main reference point of legal accountability control consists in checking whether – in a hierarchy of norms – inferior value rules conflict with higher value rules. The monitoring may either be conducted by legal or political bodies. In the case of political accountability mechanisms, an *ex ante* and *ex post* distinction may also apply. However, this would not regard congruence with the hierarchy of norms but instead the regulatory objectives declared for a specific measure. Thus, the distinction between *ex ante* and *ex post* monitoring is also present in the principal–agent approach (see above). By contractually binding the agent to *ex ante* defined procedural controls (e.g. regular reporting) and substantive standards (e.g. keeping regulatory decisions

within pre-defined limits), the principal can ensure mechanisms of *ex ante* accountability. By contrast, in the case of *ex post* monitoring, principals may rely on information from third parties ('firebell ringing'), top-down intervention ('police patrol') or reporting to national parliaments and the EP. An *ex ante* political monitoring uploading national competences to the European level would consist, for instance, in an *ex ante* preview of decisions by a parliamentary committee, such as in the case of Sweden's constitutional committee (Bergström 2019). From these considerations a further line of research on regulatory effects and accountability mechanisms in financial markets would analyse institutional mechanisms of *ex ante* and *ex post* monitoring with respect to procedural and substantive political accountability, given initially stated regulatory objectives.⁸

8.4 CONCLUSION

To conclude, this volume has explained the European regulatory structure of financial governance flowing from the perspectives of mandates by international agreements, competition between the large regulatory powers of the EU and the US, the interaction between public and private regulators and digital financial innovation. While many of our hypotheses regarding the drivers of centralisation, decentralisation and fragmentation of regulatory structures have been confirmed, we have also found some disconfirming evidence that requires further theoretical refinement in future research. In particular, if we aim to provide a complete explanation of the centralisation, decentralisation or fragmentation of a regulatory structure – rather than probing the explanatory power of a particular theoretical approach – the evidence provided by our empirical analyses points to additional explanatory factors needing to be included in our explanatory framework.

Once the regulatory structures are identified and explained, however, a further research question arises: what do these structures mean when we examine them with regard to their regulatory effects and the linked mechanisms of accountability? Hence, this book has also revealed the next research steps that follow from its findings. In particular, we will need to analyse the effects of the regulatory measures under MiFID II and CMU that we have focused on in this volume and investigate the conditions under which they have been subject to accountability mechanisms of what nature and with what outcome.

NOTES

1. More precisely, CCPs have been regulated by the recently reformed European Financial Markets Infrastructure Regulation (EMIR).

2. Although EMIR is governed on a Qualified Majority Voting (QMV) legal basis (Art. 114 TFEU).
3. Carl Fredrik Bergström, oral comment at the ‘Governing Finance in Europe’ workshop at the Hertie School of Governance, Berlin, 7 and 8 November 2019.
4. Walter Mattli (2019) argues that there is also much intentional obfuscation in financial market transactions in order to obtain a relative advantage over competitors (e.g. ‘stuffing’). However, this cannot be said for regulators. See also Karremans (2019).
5. The overall impact of individual regulatory measures on financial transactions in their worldwide interlinkedness, as has been argued for instance by Haldane and Madouros (2012), does not follow a linear causal logic but instead may be subject to a logic of chaos theory, where at some point individual actions in their systemic effect may produce a system stability crisis.
6. One problem is the so-called ‘multiple accountabilities disorder’ when actors become confused by the conflicting expectations of their different account-holders and can therefore not perform their duties effectively (Koppell 2005).
7. In practice, weaker forms of political accountability are widely used when seeking to hold regulatory authorities accountable. They comprise acts of political delegation to an agent and access to information (transparency) in order to control the agent. The sanctioning element is often missing or very weak in terms of its stringency.
8. Of course, legal and political accountability mechanisms are often linked. Dissatisfied target groups of a regulation in a political accountability conflict may step out of the political institutional channel, as it were, and challenge the measure by turning to a court.

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