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15 June 2006

CHAIRMAN:
THE RT.HON. THE LORD WOOLF

Attn: Bernhard Freiss
European Commission
DG Internal Market and Services
C-107 5/32
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Belgium

Dear Sirs

**Response to the Public Consultation on the Future of the Internal Market
FMLC Issue 125**

The role of the Financial Markets Law Committee (“FMLC”) is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.¹

Following the publication by DG Internal Markets and Services (“DG Markt”) of its Public Consultation on the Future of the Internal Market on 20 April 2006, the FMLC resolved to respond, addressing issues that particularly concern its remit. Therefore, this response is limited to issues that relate to legal uncertainty arising in the wholesale financial markets from initiatives taken by DG Markt in this area.²

Over recent years the FMLC has engaged extensively with DG Markt on aspects of the Financial Services Action Plan, where the legislation proposed by the EU has raised issues of legal uncertainty affecting the financial markets. Therefore, the FMLC has gained experience of bringing issues to the attention of DG Markt and of working with DG Markt to find a solution. The FMLC would like to take this opportunity to thank DG Markt for the constructive and open way it has addressed the FMLC’s concerns over this time and looks forward to continuing the productive relationship that has developed.

As a general comment, the FMLC is of the view that DG Markt is mostly doing a good job in implementing the Financial Services Action Plan. Issues have arisen during this work, which the FMLC, among others, has sought to bring to DG Markt’s attention. It is recognised that DG Markt works under difficult circumstances with limited resources available for the complex and important work DG Markt undertakes. Further, the FMLC appreciates that the process

¹ The members of the FMLC can be found on the website, www.fmlc.org. Please note that, in light of their official responsibilities, Clive Maxwell and Sally Dewar took no part in the FMLC’s consideration of this issue.

² As will be seen from the points discussed below, this response is primarily concerned with issues concerning the priorities of better regulation and better implementation and enforcement identified in the Consultation.

leading to the final legislation adopted by the EU is a political one, involving negotiation of the text of the directive or regulation by Member States, who may have different national approaches to the issues being addressed. However, the FMLC welcomes DG Markt's current commitment to address some of the issues encountered in the past and therefore considers that the general direction taken by DG Markt is the right one.

From the FMLC's perspective, which is focused on addressing issues of legal uncertainty, there are four key areas that DG Markt should pay particular attention to in order to ensure that better internal market measures are delivered. These are:

1. the need for greater consistency between different directives, so that there are no conflicts;
2. the need for legislation to be flexible and that avoids static solutions that cannot respond to the dynamics of market developments;
3. the need to address linguistic and taxonomic issues with directives, to avoid issues arising in relation to translations or a clash of concepts;
4. the need to avoid unintended consequences, which is best addressed by expanding the use of expert groups and regulatory impact assessments.

These key areas are expanded on below.

Greater consistency between directives

Frequently, aspects of the internal market are governed by more than one directive. As the European law framework for the internal market becomes more sophisticated and deals with more complicated areas of commercial activity, this trend is likely to increase. However, in order for the internal market to function effectively, it is important that directives addressing a particular aspect of the internal market, or closely related aspects, are consistent between themselves.

The Financial Services Action Plan provided for a package of measures to improve the working of the financial markets across Europe, including four directives in the securities field (referred to here as "the Securities Directives").³ The Securities Directives were intended to put in place a number of measures that would provide the basis for the integration of the European capital markets, making the cross-border operation of these markets more efficient.

Crucial to the operation in practice of the Securities Directives is that they work together consistently, such that concepts within each of the Securities Directives have the same meaning and that requirements on market participants across the Securities Directives are complimentary. However, this is not the case in relation to all aspects of the Securities Directives. The FMLC has previously raised this particular point with DG Markt in a paper dated December 2005,⁴ which highlighted a number of issues where the Market Abuse Directive and Transparency Obligations Directive did not immediately appear to work effectively together in relation to issues of regulatory notification.

Legislation that is flexible

One issue that is particularly important in the context of the financial markets is the need for legislation that is able to effectively accommodate market developments. Financial markets are constantly innovating and creating new products in order to meet the needs of investors and issuers. However, the pace of this change is such that legislation is often left behind.

³ The Securities Directives are the Market Abuse Directive (Directive 2003/6/EC, OJ L 96, 12.4.2003), the Prospectus Directive (Directive 2003/71/EC, OJ L 345, 31.12.2003), the Transparency Obligations Directive (Directive 2004/109/EC, OJ L 390, 31.12.2004) and the Markets in Financial Instruments Directive (Directive 2004/39/EC, OJ L 145, 30.4.2004).

⁴ FMLC Issue 119 – Conflicts between FSAP Directives, available at www.fmlc.org/papers/Issue_119report.pdf

The result is that beneficial developments in the market can be undermined or blocked by inflexible legislation, which drives the market to continue to use old and outdated structures for financial products that might not necessarily offer the best solution for investors and issuers. This situation is also often detrimental to legal certainty, as market participants seek to fit new structures into old legislative frameworks or refrain from developing new and more robust products in the face of static legislation.

A recent example where the FMLC came across this issue was in relation to the Capital Requirements Directive. The definition of eligible assets in this directive sought to set out an EU-wide standard definition for covered bonds; bonds falling within this definition enjoy a lower risk capital weighting. The concerns raised by the FMLC in relation to the definition centred on the fact that it was drafted in such a way that it was uncertain whether many covered bonds would come within the definition, due to the different structures adopted in Member States and also due to the dynamic nature of the asset pool that backed the bond. The source of this uncertainty was that the definition adopted unnecessarily detailed rules to determine the types of bonds included, in contrast to the rating driven approach adopted elsewhere in the directive.

Linguistic/taxonomic issues

The drafting of EU legislation gives rise to a number of particular practical challenges, as a legal instrument must be developed that can be applied in all Member States. Each Member State has their own language and legal tradition, which means that particular care is needed to develop the different texts, so that they are consistent in meaning in all Member States. This issue is of particular importance to a body such as the FMLC, as legal uncertainty can often arise from the application of unclear legislation, either because the concepts are not well understood or correctly identified or because of linguistic or translation issues importing uncertainty.

It is acknowledged that much effort goes into addressing linguistic issues at an EU level. However, there are still times when issues with draft legislation arise, which can be illustrated by a recent FMLC project, although one relating to a proposal from another Directorate General. The recent Rome I Regulation proposal from DG Freedom, Security and Justice has been considered by the FMLC in a paper dated April 2006.⁵ In this paper, the FMLC identified a number of issues with the English text of the proposal in relation to assignments and subrogation (see paragraphs 15 and 16 of the FMLC paper). These issues resulted in legal uncertainty as to the intended consequences of the proposal.

A further related point concerns the approach to the use of regulations rather than directives to enact EU legislation. This approach is increasingly being taken in the context of the Level 2 legislation adopted under the Lamfalussy framework for Financial Services Action Plan measures. There are clearly questions as to whether a regulation or a directive should be used in a particular context and this is best addressed on a case by case basis. The key concern however relates to the language used to draft regulations, which, as directly effective measures under EU law, require greater certainty as to their terms than is the case for directives. It is therefore crucial that DG Markt adopts a different style when drafting regulations that recognises the need for greater precision in the text.

Avoiding unintended consequences

The legislative process is an intrinsically challenging one, requiring those preparing the legislation to analyse complex issues and develop proposals that address the issues identified. These challenges are at their most difficult in the financial markets arena, where sophisticated structures and processes are adopted in an innovative environment. From the perspective of producing good legislation, and particularly legislation that is free from issues of legal uncertainty, it is crucial that unintended consequences are avoided, so that the financial markets are not impeded.

⁵ FMLC Issue 121 – European Commission Final Proposal for a Regulation on the Law Applicable to Contractual Obligations (“Rome I”), available at www.fmlc.org/papers/April06Issue121.pdf

The Commission, and DG Markt within it, has already started to put in place a number of measures that the FMLC considers would greatly assist DG Markt in developing legislative proposals that avoid unintended consequences. In particular, the expansion of the use of expert groups and regulatory impact assessments is, in the FMLC's view, key to achieving this objective.

The use of expert groups clearly has a number of advantages for DG Markt in the financial markets sphere. The ability to tap into the views of experienced financial markets participants should allow DG Markt to gain a much deeper understanding of the issues and thus foresee issues that might not otherwise be identified. Further, the use of expert groups would allow DG Markt to leverage its own limited resources, enabling it to be more effective. One point to make however is that it is crucial to ensure that the membership of expert groups draws on those with real and in-depth experience of the particular aspect of the financial markets to be covered by the group.

The Commission as a whole has been seeking to make greater use of regulatory impact assessments and has set out a framework in its Impact Assessment Guidelines published on 15 June 2005. The FMLC welcomes this initiative and urges DG Markt to follow this best practice to ensure that future legislative proposals are proportionate and focused in addressing the issues they are aimed at. The greater use of impact assessments and the systematic analysis of the likely impacts of EU interventions in a particular area will help ensure that all impacts are identified and unintended consequences avoided.

One additional initiative that DG Markt may wish to consider relates to the use of pilot projects in relation to internal market initiatives. Such pilot projects would allow new regulatory concepts to be introduced gradually and in a controlled and monitored way. The experience gained would then enable the concept to be refined and any uncertainties to be addressed before the wider application of the legislation.

Additional comments

The FMLC considers that there are a number of other areas that should be noted in addition to the key areas identified above.

First, the FMLC would like to strongly endorse the better regulation agenda now being followed by DG Markt and the recent change to thinking more carefully about whether legislation is needed at all. New legislation almost inevitably leads to some degree of uncertainty and therefore there are benefits in working with the financial markets to develop solutions away from the legislative arena, both in terms of use of resource and flexibility of outcome.

Second, initiatives taken elsewhere in the Commission increasingly have an affect on efforts by DG Markt to develop EU wide markets, particularly in the financial sphere. The FMLC considers that, where possible, the work of the Commission as a whole would benefit from DG Markt's assistance to other Directorates General where their proposals affect areas within DG Markt's field. Recent examples of such areas relate to the Rome I Regulation proposal referred to above, European Contract Law and the CFR project, jurisdiction clauses and the recent cases in relation to the Brussels Convention (now Regulation) and the market for the trading of European emissions allowances.

Third, it is important for DG Markt to maintain a focus on the impact of legislation it proposes in the context of international competitiveness. Experience elsewhere has shown that poorly thought out legislation can have a significant impact on the financial markets and drive activity to other jurisdictions. From the perspective of legal uncertainty, such issues can discourage financial market participants from engaging in a particular market and instead conclude a transaction in a jurisdiction where there is greater legal certainty.

Fourth, the focus of DG Markt on ensuring that internal market rules are correctly implemented and applied in Member States is positive. However, in addition to post-implementation enforcement, DG Markt also needs to ensure that the implementation of

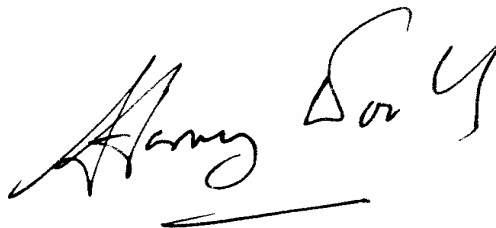
directives is not undermined by national laws adopted by Member States during a directive's pre-implementation period that may undercut its objectives.

Fifth, the FMLC considers that there is significant benefit that comes from Commission guidance on particular legislative measures and that work in the transposition workshops is particularly important. Many of the issues that can arise in relation to legal certainty can be resolved through guidance or coordinated transposition.⁶

Conclusion

As stated above, the FMLC is broadly supportive of the direction taken recently by DG Markt in the financial markets area. The current public consultation highlights a number of issues that the FMLC considers need to be addressed in order for legislation that is free from legal uncertainty to be delivered. The stated priority of better regulation is one the FMLC shares and therefore the FMLC would urge DG Markt to follow the Commission's Guidance on Impact Assessments referred to above. Further, focus on the key issues raised in this letter would also, the FMLC hopes, assist DG Markt in delivering the better regulation agenda.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Lord Woolf', with a horizontal line underneath.

Lord Woolf

⁶ An additional point that follows on from these final two observations on implementation issues is that there have been a number of examples where the recitals and the operative text of directives or regulations have been inconsistent. A well known example is in relation to the Prospectus Directive where recital 12 states that depositary receipts and convertible notes are to be treated as non-equity securities but article 2.1(b) says the opposite. This inconsistency may arise from the political process or be the result of the recitals and the operative text being drafted by two different people. However, the result is that implementation of the directive is hampered and legal uncertainty is created.