Commentary: Adventures in Convergence

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As I write, U.S. financial services reform legislation is front-page news in financial journals. The Senate is currently debating and offering amendments to the more than 1,300 page draft passed by Senator Dodd's Banking, Housing and Urban Affairs Committee. The House has already passed its version. Eventually, the two versions will have to be reconciled in Conference, passed again by each legislative chamber, and sent to President Obama for signature.

In this Age of Convergence, the members of the G-20 have all agreed to hold hands by instituting financial services legislation intended to achieve the same results. The idea is to avoid "regulatory arbitrage" where a financial services firm will decide to locate in a particular jurisdiction because its regulations are considered to have a "lighter touch" than other jurisdictions. As might be expected, while the Senate is bogged down debating amendments to Dodd's bill, the Economic and Monetary Affairs Committee of the European Parliament last Monday issued its proposal for European financial services reform. This proposal will now be considered by the entire European Parliament, and if the European Council agrees with what is passed by the Parliament, or the versions of each legislative chamber can be reconciled, the reform legislation will become law, without the need for any further signature by anyone.

The European legislative process was changed dramatically by the adoption of the "Dublin Treaty" last year, which, among other things, greatly enhanced the power of the central European government over its national members. This is not unlike the U.S. experience where our Civil War led to a great increase in federal power over the fifty States.

In Europe, the European Parliament now is roughly equivalent to the U.S. House of Representatives, while the European Council is the "Upper House," like the U.S. Senate. However, only the members of the European Parliament are directly elected by the people of Europe. Members of the European Council are appointed by each of the European Member Nations, one for each Nation. While that may seem odd, for more than a century, members of the U.S. Senate were also appointed by each of the States of the Union.

While nothing can become law in Europe without the approval of the Parliament and Council, oddly enough only the European Commission, which is essentially the European executive branch, can initiate legislation. The European legislatures must wait until the Commission drafts legislation before they can act by modifying it.

The European Commission produced its proposals for financial regulatory reform soon after the G-20 Pittsburgh Summit in September 2009. The European Council adopted its position in December 2009, which significantly watered down some of the Commission's proposals. Then the European Parliament produced a thunderbolt: It declared the proposals of the Commission and the Council unacceptable in December 2009. The Parliament's Economic and Monetary Affairs Committee produced their own version last Monday, and it is a much more powerful regulatory proposal. This proposal is scheduled to be voted on by the full Parliament within the next week.

The European Commission proposed to create three regulatory agencies over Banks (European Banking Authority or EBA), Insurance (European Insurance and Occupational Pensions Authority or EIOPA) and Securities (European Securities and Markets Authority or ESMA), to replace the current European advisory committees. These new regulatory agencies would be presided over by a new systemic risk regulator, called the European Systemic Risk Board (ESRB). A systemic risk regulator also is an important component of the current legislation being debated in the Senate.

Merely creating these regulatory agencies and giving them real governmental, rather than advisory, powers would go a long way towards bringing the European regulatory system into convergence with the U.S. regime. The roles of the Federal Reserve Board (together with the FDIC) and the Securities and Exchange Commission are analogous to the new European Bank and Securities regulatory agencies. On the other hand, the United States does not currently have a federal insurance regulator. The Dodd proposal would institute a U.S. federal insurance regulator, but most regulatory functions would continue to be performed by each of the fifty States.

The European Parliament would greatly expand the powers of these new agencies beyond what was contemplated by the European Commission.

The Commission had conceived of the role of the ESRB as advisory. So, for example, the ESRB would have been able to warn of a crisis, but not declare one. The ESRB would have been permitted to ask each of the three new financial services agencies for information, but would not have been empowered to reach beyond the information that could be gathered by these agencies. The Parliamentary fix would greatly expand the powers of the ESRB to declare an

emergency and obtain information independent of European Commission action. This would effectively make the ESRB an independent regulatory agency, much like the Fed and the SEC, rather than an executive branch agency, like the U.S. Treasury. Since the ESRB is conceived as directing the work of EBA, EIOPA and ESMA, this shift would also render them independent of Commission influence as well. The practical effect would be to give the European Parliament much more power over their operations, and would lessen the control of the European Commission.

Under the Parliament's version of reform, the EBA would have direct authority over cross-border banks and could command national regulators to act as its agents in dealing with these institutions. Two pan-European funds would be created – one a bailout fund and the other a depository insurance fund, like our own FDIC. Recent compromises in the U.S. Senate have eliminated the proposed creation of a $50 billion bailout fund.

ESMA would be granted authority to ban certain financial products if they were considered too risky. This is a power that the United States has never granted to the SEC, although the current reform legislation contemplates that the new systemic risk regulator might be able to ban certain products.

The European Parliament would locate the ESRB, as well as the new EBA, EIOPA and ESMA regulatory agencies, in Frankfurt. Since the European Commission is located in Brussels, this would effectively make it more difficult for the European Commission to control them. This would be something like moving the headquarters of the Fed and SEC to Chicago. Parliament would have oversight authority over the new agencies, much like Congress has oversight authority over independent agencies.

Reflecting the shift in power resulting from the Dublin Treaty, the European Parliament would make it much more difficult for a member nation to resist the implementation of a decision by the new regulatory agencies. Agencies would be empowered to "deputize" officials in each member nation to carry out agency directives.

The popular European drive to implement much stronger financial services regulation than proposed by the executive branch is mirrored in the United States. The Obama administration's proposals, which formed the basis for the Dodd bill, were relatively mild. The amendments currently being adopted by the Senate on a bipartisan basis have added so much regulatory power to the bill that even Senator Dodd has tried, but failed, to defeat some of them.

The legislative process currently underway in Europe and the United States demonstrates yet another challenge for advocates of convergence.

At the G-20 Pittsburgh Summit on September 24-25, 2009, representatives from the European Commission and the Obama Administration hammered out the conceptual framework for convergent financial services regulatory reform. I suspect a lot of the details were also agreed, although the devilish details were not part of the pablum served up in public statements after the event.

The popularly elected legislatures on both sides of the Atlantic are having none of it. Instead, they are insisting on greater regulation of the financial services industry than was agreed at the G-20. But, rather than working together to produce convergent regulation, they are going their separate ways to produce their own culturally-informed version of regulation.

After this is all done, lawyers like me will be sifting through the rubble to locate opportunities for regulatory arbitrage. Since legislatures have departed from the G-20 compromises in favor of their own agenda, my guess is that regulatory arbitrage will be a good business for lawyers for some time to come.

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