The European Court's dismissal of the UK's challenge to the short selling regulation

1. On 22 January 2014 the Court of Justice of the EU ("CJEU"), in a controversial but not unanticipated decision[1], dismissed the UK's challenge to the powers conferred on the European Securities and Markets Authority ("ESMA") in the short selling regulation[2] and handed down a judgment that could encourage the EU to transfer further powers to EU bodies and limit the oversight of these bodies.

Background

2. The provisions of the short selling regulation were analysed in our client alert of 30 October 2012 entitled "*Short Selling and Credit Default Swaps - New EU Rules Enter into Force on 1 November 2012*"[3]. In summary, the regulation focuses on shares admitted to trading on a trading venue in the EU and the sovereign debt of the EU Member States. It bans naked short sales of shares and sovereign debt in the EU, imposes a general ban on uncovered sovereign credit default swaps and requires that certain net short positions are privately notified to the relevant national regulator and, at higher levels, are publically disclosed. It contains various exemptions, including for shares of a company admitted to trading on a trading venue in the EU where the principal venue for the trading of the shares is in a third country and in relation to transactions carried out in the performance of market-making activities and when acting as an authorised primary dealer. The short selling regulation also gives various emergency powers to curb short selling to national regulators and to ESMA. It was the powers that were conferred on ESMA that were the subject of the UK's legal challenge.

3. Article 28 of the short selling regulation gives ESMA the power to prohibit or impose conditions on the entry into short sales or similar transactions and to require such persons to notify or publicise net short positions. The trigger for the use of the power is set out in Article 28(2) and is where ESMA assesses that:

   (a) the measure it is considering imposing addresses 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 EU;

   (b) there are cross border implications; and, significantly,

   (c) competent authorities have not taken measures to address the threat or the measures that have been taken do not sufficiently address the threat.

   There are no criteria to guide ESMA's assessment, although the Commission has adopted a delegated regulation to specify the criteria and factors to be taken into account when determining when the threats referred to in (a) above arise[4] which involve further questions of discretionary judgment[5].

1 Case C-270/12 *United Kingdom v European Parliament & Council of the EU*

2 Regulation 236/2012) of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps

3 The client alert can be found here http://www.mayerbrown.com/files/Publication/cbf5c52b-e685-4517-928c-ec9bd22b55ff/Presentation/PublicationAttachment/3c0cac58-96b7-4904-a2e2-f31ebdd9d4a4/FSRE_Short_Selling_1012.pdf

4 Commission Delegated Regulation (EU) No 918/2012 of 5 July 2012 supplementing Regulation (EU) No 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps with regard to definitions, the calculation of net short positions, covered sovereign credit default swaps, notification thresholds, liquidity thresholds for suspending restrictions, significant falls in the value of financial instruments and adverse events.

5 See Article 24(1)(a) which provide that threats "include any act, result, fact, or event that is or could reasonably be expected to lead to ...serious financial, monetary or budgetary problems which may lead to financial instability concerning a Member State or a bank and other financial institutions deemed important to the global financial system such as insurance companies, market infrastructure providers and asset management companies operating within the Union when this may threaten the orderly functioning and integrity of financial markets or the stability of the financial system in the Union.".

4. Article 28(3) sets out certain further issues ESMA should take into account in deciding whether it needs to take measures. These are the extent to which the measure it is considering imposing:

   (a) significantly addresses the 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 EU or will significantly improve the ability of competent authorities to monitor the threat;

   (b) does not create a risk of regulatory arbitrage;

   (c) does not have a detrimental effect on the efficiency of financial markets, including by reducing liquidity in those markets or creating uncertainty for market participants, that is disproportionate to the benefits of the measure.

   There are no criteria on how ESMA should determine whether a measure will have the effect set out above nor what regard ESMA should have to the matters set out above when imposing a measure.

5. The power is based upon the first limb of Article 9(5) of the regulation establishing ESMA[6] which provides that ESMA "*may temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union in the cases specified and under the conditions laid down in*" other legislative acts. The regulations establishing the other European Supervisory Authorities ("ESA")[7] mirror that in respect of ESMA *mutatis mutandis* and thus contain provisions identical to Article 9(5).

6. Article 28 of the short selling regulation is the first example of such a power being conferred on an ESA but the recently agreed Markets in Financial Instrument Regulation ("MiFIR") contains provisions which are also based on Article 9(5) of the ESMA regulation[8]. In addition, Articles 17 – 19 of the ESA regulations confer powers on the ESAs (in the case of a breach of EU law, in the case of an emergency situation as declared by the Council and in cases of binding mediation respectively) which permit the ESAs to impose direct decisions on national regulators and ultimately on firms. These powers have yet to be exercised but raise similar issues to those discussed in this article.

Legal challenge

7. The EU Treaties, which contain the EU's legislative framework, do not provide for the creation of EU agencies but nor do they exclude them. There has been no serious disagreement about the need to delegate some regulatory powers and so the objective usefulness of EU agencies has not been challenged but, as agencies do not have a legal base in the Treaties, there are limits on the extent of the powers can be delegated to them. The UK argued that these limits meant that the power conferred on ESMA in the short selling regulation was unlawful.

8. The UK grounds of challenge to Article 28 were as follows:

   (a) It is contrary to the *Meroni*[9] principle which provides that EU institutions may delegate powers to independent or executive or regulatory bodies as long as the delegation relates only to clearly defined executive competencies, meaning that no power which may make possible decisions on policy choices may be granted to the delegated body. In *Meroni* a distinction was made between "clearly defined executive powers the exercise of wh*ich can, therefore, be subject to strict review in the light of objective criteria determined by the delegating authority*" and "*a discretionary power, implying a wide margin of discretion which may, according to the use which is made of it, make possible the execution of actual economic policy*". The former can be delegated to a European body but the latter cannot. The UK reasons for reliance on the *Meroni* principle included the following:

      (i) The criteria as to when ESMA is required to take action under Article 28 entail a large measure of discretion.

      (ii) ESMA is given a wide range of choices as to what measure or measures to impose, and what exceptions to specify, and these choices have very significant economic policy implications.

6 Regulation (EU) 1095/2010 establishing the European Securities and Markets Authority.

7 The European Banking Authority and the European Insurance and Occupational Pensions Authority.

8 Cf. the provisions (yet to receive their final numbering) which confer powers on ESMA to temporarily prohibit or restrict the marketing, distribution or sale of certain financial instruments, to temporarily prohibit or restrict a type of financial activity or practice, to require that steps be taken to reduce the size of or to eliminate the position or exposure entered into via a derivative and to limit the ability of a person to enter into a commodity derivative.

9 Case 9/56 *Meroni* v *High Authority* [1957 & 1958] ECR 133.

(iii) The factors which ESMA must take into account contain tests which are highly subjective.

(iv) ESMA has a broad discretion as regards the application of policy to any particular case.

(b) Article 28 purports to empower ESMA to impose measures of general application which have the force of law contrary to the case of Romano[10].

(c) Article 28 purports to confer on ESMA a power to adopt non-legislative acts of general application that is not consistent with Articles 290 and 291 of the Treaty on the Functioning of the EU ("TFEU") which provide the only basis for delegations of power at EU level.

(d) Article 28 cannot properly be adopted under the chosen legal base, Article 114 TFEU, which can only be used for the purposes of internal market harmonisation.

9. The Advocate General to the CJEU, Advocate General Jääskinen, delivered his opinion on 12 September 2013[11]. His role was to analyse the law and advise the CJEU on its decision. Opinions of Advocate Generals have persuasive, rather than binding, effect but are, in practice, followed by the CJEU in most cases. Advocate General Jääskinen upheld ground 4 only. He was of the view that the conferral of decision-making powers on ESMA *"in substitution for the assessments of the competent national authorities"* does not amount to internal market harmonisation so as to permit the use of Article 114 TFEU and, although the power set out in Article 28 can be conferred on ESMA, allowing an EU agency to substitute its decision for a national decision is so significant that legislation permitting this transfer of competence must be adopted under Article 352 TFEU. Article 352 requires the unanimous agreement of all Member States and only the consent of the European Parliament whereas Article 114 requires a qualified majority vote in Council and joint adoption by the Parliament. The Advocate General's opinion was, therefore, significant, particularly given the recent direction of travel in the regulation of financial services which has seen an increasing number of regulatory powers being transferred to EU level.

10 Case 98/80 *Giuseppe Romano v Institut national d'assurance maladie-invalidité* [1981] ECR 1241.

11 See here http://curia.europa.eu/juris/document/document.jsf?text=&docid=140965&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=127454

The decision of the CJEU

10. The judges of the CJEU deliberate on the basis of a draft judgment drawn up by the judge rapporteur. Each judge involved in the matter may propose changes but decisions of the CJEU are taken by majority and dissenting judgments are not produced: there is just one judgment made public. The judgments, which are usually fairly short, are signed by all the judges who took part in the deliberation and the outcome is handed down in open court.

11. The CJEU handed down its judgment on the UK's challenge on 22 January 2014. It disagreed with the UK and, more unusually, with its own Advocate General. It dismissed all four heads of challenge for the reasons summarised below:

(a) The CJEU concluded that the *Meroni* principle was satisfied because ESMA's discretion is limited by various conditions and criteria, ESMA is required to *"examine a significant number of factors"*, ESMA can take only certain types of measures and ESMA has duties to consult and notify various bodies.

(b) ESMA does adopt measures of general application but this is envisaged by Articles 263 and 277 TFEU and is not at odds with *Romano*.

(c) The delegation of powers to ESMA was valid even though it did not *"correspond to any of the situations defined in Articles 290 TFEU and 291 TFEU"* and the Treaties do not contain any specific provisions for the delegation of powers to EU agencies.

(d) The CJEU did not specifically address the Advocate General's argument. It stated simply that Article 28 was directed at harmonisation and its purpose was to improve the internal market in financial services so Article 114 was an appropriate legal basis.

Conclusion

12. The CJEU's reasoning is skeletal and, in parts at least, opaque but there is no avenue of appeal. The decision appears to deprive the *Meroni* principle, which placed limits on the powers that could be conferred on EU agencies, of all real effect as Article 28 of the short selling regulation appears to give ESMA significant discretion without oversight by an EU institution.

13. The Court in Meroni referred to the "*fundamental guarantee*" as to "*the balance of powers which is characteristic of the institutional structure of the Community*" and said "*[t]o delegate a discretionary power, by entrusting it to bodies other than those which the Treaty has established to effect and supervise the exercise of such power each within the limits of its own authority, would render that guarantee ineffective*". The effect of the Meroni doctrine is evident in the EU legislation that has been adopted since the establishment of the ESAs. There has been a tendency to attempt to limit the discretion of the ESAs by setting out criteria and conditions to guide their decision making or by constructing procedures whereby the ESA decisions require endorsement, typically by the Commission. The decision of the CJEU in the short selling case could be used to support the case for the conferral of further discretionary decisions on the ESAs, perhaps even without the requirement of endorsement by the Commission.

14. The decision, although not unexpected, is also likely to cause concern in the UK and some other Member States which are already uneasy with the way in which the EU's legal framework is being stretched as the EU seeks to transfer existing national powers and confer wide new powers on EU bodies whilst avoiding the contentious question of whether this actually necessitates Treaty change.

15. As set out above at paragraph 6, the decision will have immediate read-across to MiFIR but it is of wider significance. The Single Resolution Mechanism, which is currently in trialogues, includes the proposal for a new EU agency which would determine the application of resolution tools and the use of a mooted single resolution fund. The *Meroni* principle and the opinion of Advocate General Jääskinen had been used in Council negotiations to limit the role of the proposed agency and to justify oversight by the Council but the ongoing discussions about its powers are now likely to focus on political and practical rather than legal concerns. The decision is also relevant to the ESAs' existing powers, also as described above, and to the current review of the ESA powers. The decision is not, however, relevant to the European Central Bank's ("ECB") supervision of banks in the Eurozone as the ECB is an EU institution established under the Treaties (as opposed to an EU agency established under secondary legislation) and thus the parameters of its powers are found in the EU Treaties themselves.

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