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Abstract

This paper assesses the effectiveness of the Meroni doctrine in the light of the recent judgment in the ESMA case. The first part explains in detail the problem of delegation of powers in the EU from the perspective of the principal-agent theory and complements it with the analysis of the trade-off between different levels of independence and accountability of agencies. A simple economic model is developed to illustrate the relationship between the independence and accountability of an agency. It shows that it is the accountability mechanism that induces the agent to act, rather than the extent of his independence. The paper also explains the inter-temporal interactions between the principal and the agent on the basis of the incentives in place for the different players.

The second part is devoted to analysis of the functioning of ESMA in the context of its delegated powers. After the presentation of main aspects of the regulatory framework establishing ESMA, the paper continues with an analysis and interpretation of the discretionary powers of ESMA. The rather rigid position of the Court of Justice in relation to the Meroni doctrine seems to be unsuitable to delegation of complex regulatory tasks. This is particularly evident in the case of financial markets. Finally, the judgment does not examine in any detail whether and how the principals - i.e. the EU and Member States - are best able to evaluate the quality of ESMA decisions and regulations and whether there are different but more effective accountability mechanisms.

Introduction

The purpose of this paper is twofold. It considers the complexity of the act of delegating tasks and, on the basis of the lessons it draws, it reviews the recent judgment of the Court of Justice in the case brought by the UK against the European Parliament and the Council of the EU. The UK sought partial annulment of a regulation that had conferred powers to the European Securities and Markets Authority [ESMA] to control “short selling”.

The Court ruled that the powers of ESMA were sufficiently delineated and therefore ESMA did not have a large margin of discretion to conduct autonomous policy. The relevant ESMA regulation was, therefore, compliant with the so-called “Meroni” doctrine.

In order to assess whether the judgment covered all the relevant issues, this paper examines first the nature of relations between principals and agents, why principals may want to delegate tasks and how they may curtail the discretion of agents. It argues that in situations such as those concerning the regulation of financial markets, a principal has conflicting objectives. On the one hand, he wants to control the agent while, on the other, he wants to allow the agent enough room for manoeuvre to decide on issues which cannot be sufficiently specified ex ante.

The paper also explores the trade-off between independence and accountability. It concludes that the Court of Justice appeared not to recognise this trade-off, or appreciate its impact on the quality of the regulation adopted by an agency and the usefulness of allowing adequate discretion or independence to the agency in order to achieve what cannot be achieved by its principal, which in this case is the EU. The paper concludes that the Meroni doctrine is unsuitable for assessing the effectiveness of delegation of complex regulatory tasks.

The problem of delegation

The delegation of tasks by a principal to an agent has to solve two problems: i) the definition of the objective that the agent should achieve on behalf of the principal and/or ii) the definition of the process through which the agent should achieve whatever objective is set by the principal. This is because by defining the process, in addition to the objective, the principal deprives the agent from the excuse that the principal has set an objective that cannot be realistically achieved. This is especially true when the objective is dependent on the process. A case in point is the enforcement of anti-trust rules. Since the mid-1990s when the European Commission adopted a leniency policy, whereby undertakings providing information on cartels are themselves exempt from fines, most if not all cartels prosecuted by the Commission have been uncovered after information from whistle-blowers. The

reform of the process of gathering information and the new procedural instruments available to the Commission have had a significant impact on its ability to enforce the anti-cartel prohibition.

In other situations, however, the definition of the objective or the process is sufficient [e.g. asking someone to mow a lawn (setting the objective while leaving the process undefined)]. In yet other situations, only the process can be defined instead of the objective. For example, when carrying out research, it is the procedure that is normally defined rather than the outcome of the research [which, by definition, is unknown].

In order to appreciate the problem of meaningful delegation of tasks it is instructive to begin with an example where it is possible to define both what needs to be achieved and how it can be achieved. In the Official Journal of the European Union of 5 February 2010 [L 34] there is a 10-page description of how to make “pizza napoletana”. Commission Regulation 97/2010 defines the ingredients, how they should be mixed to make the dough, how to knead the dough and prepare the basis of the pizza, what toppings to put and how to put them and then how to bake the pizza. It leaves very little to individual discretion. This is because the objective is to make pizzas that conform to a particular standard so that they look and taste identically.

The task of making identical pizzas appears to be feasible because it has been performed many times and the effects of even small variations in inputs [e.g. ingredients, working and shaping the dough] on outputs [pizzas] have been studied and documented extensively. There is also a pretty clear understanding of what the output should look like. For example, pizza napoletana is described as “a round product baked in the oven with a variable diameter not exceeding 35 cm and a raised rim and the central part is garnished. The central part is 0,4 cm thick, with a tolerance of $\pm 10\%$, and the rim is 1-2 cm thick. The overall pizza must be tender, elastic and easily foldable into four.” To repeat, both inputs [or process] and outputs [or objectives] are well-defined.¹ Yet, it takes the Commission about 4,000 words to describe how to make the pizza so that it comes out the way it is supposed to.

Now consider the task of preventing persons or institutions from short selling instruments whenever that sale would create financial advantages from holding instruments other than those which are sold short. This is, in a nutshell, Article 28 of Regulation 236/2012 on short selling. This Article defines the intervention powers, in exceptional circumstances, of the European Securities and Markets Authority [ESMA]. Short selling is the sale of shares, which are not actually owned by the seller, in the hope that their price will eventually decline so that they can be bought back at a lower price.

¹ In general we refer to inputs and processes, on the one hand, and outputs and objectives, on the other, as interchangeable concepts, unless it is necessary to differentiate them.

The tasks of ESMA are different from the “pizza tasks” in two important respects. First, it is not a priori clear what exactly must be prohibited on an ex ante basis [this can be considered to be the “input” side] and, second, in case certain things are prohibited, it is not sure whether their effect will be the desired ex post outcome [this can be considered to be the “output” side], given that a precise description of the desired outcome is difficult to define unambiguously. The desired outcome is financial stability but this is not something that exists on its own. It is a composite concept that depends on many other conditions being in the right state. The problem is that we are not sure about the causal relationships between inputs and outputs, whether there are any critical values or thresholds or whether the outputs can be described exhaustively.

There are other factors at play that add to the complexity of ESMA’s tasks, two of which are the following. First, the ingredients that go into pizza napoletana do not “react” to the fact that they are prescribed in the relevant Commission regulation. By contrast, financial operators may attempt to evade whatever is proscribed in ESMA regulations.

Second, the result of baking a pizza is fully observable. By contrast, the actions of financial operators are only imperfectly observable. They need to be detected and then establish that those actions can indeed have a negative impact on financial stability. The latter may be further complicated by the fact that even if short selling has negative effects it may also have positive effects. Then it may be very difficult to measure their net effect.

Both of these factors, combined with the difficulty of defining precise inputs [or, in the case of ESMA, behaviour that should be prohibited] and precise outputs [or, in the case of ESMA, desired market outcomes] make it particularly challenging to assign specific supervisory tasks to any entity, European or national.

The economic theory on the principal-agent relationship has examined at length how agents can be motivated to produce results that benefit principals.² The crux of the problem is that the principal can only imperfectly observe the actions of the agent. So the principal cannot be sure how much effort is exerted by the agent. The typical solution in the literature is to align the interests of the principal with those of the agent by allowing the agent to benefit from outcomes that are also valued by the principal [e.g. sharing of profits, granting bonuses according to revenue generated, etc].

² See, for example, Fudenberg, Drew, Bengt Holmstrom, and Paul Milgrom. "Short-term contracts and long-term agency relationships." *Journal of Economic Theory* 51.1 (1990): 1-31; Grossman, Sanford J., and Oliver D. Hart. "An analysis of the principal-agent problem." *Econometrica* (1983): 7-45; Hölmstrom, Bengt. "Moral hazard and observability." *The Bell Journal of Economics* (1979): 74-91; Nalebuff, Barry J., and Joseph E. Stiglitz. "Prizes and incentives: towards a general theory of compensation and competition." *The Bell Journal of Economics* (1983): 21-43; Sappington, David, "Incentives in Principal-Agent Relationships", *Journal of Economic Perspectives* 5.2 (1991): 45-66.

As already alluded above, the main difference between the standard principal-agent theory and the case of ESMA, apart from the fact that it has multiple principals, i.e. the European Commission and the Member States, is that none of the principals can define the desired outcome with any meaningful ex ante precision. Although it can be surmised that the outcome can be influenced by the amount of effort and ingenuity of ESMA, it is simply not known whether it is humanly possible for ESMA to eliminate all harmful short selling or by how much it can reduce it. So it is not easy either to establish effective monitoring of its activities or to devise incentive mechanisms for inducing ESMA to regulate better.³ The typical solution to this problem is to make the agency accountable in order to impel it to do the best it can. The next section considers the meaning and implications of accountability and the problem of ascertaining what it means to do one's best.

The nature of accountability

There is a voluminous literature on accountability, mostly in the fields of political science, administrative science and law.⁴ With a few notable exceptions, economics has not paid much attention to this issue. There is no universal or established definition of accountability. But at least two aspects of it are widely recognised and analysed in the broader literature.

The first aspect is that the agent has to report to a higher authority or principal. Through this reporting, the agent accounts for his decisions and actions. The second aspect is that the higher authority or principal can reward or censure the agent. The agent bears the consequences of acting improperly or insufficiently.

Other aspects of accountability concern the extent of control exercised by the principal over the agent, such as prior authorisation of decisions before they are implemented, extent of reporting by the agent and the severity of sanctions that can be applied by the principal.

It is also noted in the literature that certain forms of accountability may impinge on the degree of independence of the agent, which also affects the amount and quality of the effort exerted by the agent. By definition a principal assigns tasks to an agent because the principal cannot or does not want to carry them out himself. The agent, therefore, must be able to act without receiving further specific instructions from the principal to do so each time he acts.

³ We ignore here the possibility, which is very much real, that the principals may also have conflicting interests.

⁴ See, for example, Biela, Jan and Yannis Papadopoulos, *Strategies for Assessing and Measuring Agency Accountability*, Paper for the 32nd EGPA Annual Conference 2010, 7-10 September 2010, Toulouse; Bovens, M. "Analysing and Assessing Accountability: A conceptual framework" *European Law Journal*, 13.4 (2007): 447-468; Maggetti, Martino, Karin Ingold and Frédéric Varone. "Having Your Cake and Eating It Too: Can Regulatory Agencies Be Both Independent and Accountable?" *Swiss Political Science Review*, (2013) 19(1) p. 1-25.

It is important to appreciate that an agent without some independence cannot be accountable in the sense of being responsible for his actions. If all of the decisions and actions of the agent are controlled by the principal, then the agent can only be considered as an extension of the principal, not as someone who can act autonomously or separately. An accountable agent must enjoy a certain degree of autonomy or independence.

Independence is even more essential when agents need to use their own knowledge, experience, initiative and judgment to generate outcomes which cannot be defined ex ante and exhaustively by the principal. In these circumstances, granting the agent too little independence would defeat the purpose of assigning or delegating tasks to an agent. Attempting to control closely the actions of the agent [i.e. reducing the independence of the agent] would compromise the achievement of the end results. Therefore, accountability is a means for ensuring that independence is exercised properly, effectively or fruitfully, whenever such independence is necessary for achieving results which are ex ante unknown. It would appear that the more independent the agent, the more accountable he should be. But the unavoidable implication of conferring independence to the agent to act as he considers appropriate is that the principal must accept the consequences of the decisions and actions of the agent.

While an accountable agent must be independent to perform whatever he is responsible for, the converse is not necessarily true. An independent agent is not necessarily accountable. Yet, a principal must make an independent agent accountable, otherwise he may do whatever he wants to do irrespective of the wishes of the principal. So it is in the interests of the principal that the agent is independent and at the same time accountable too.

But there is a problem here. Certain forms of accountability which are too intrusive or are applied ex ante [e.g. requirement for prior and detailed notification and authorisation of intended action] may curtail the independence of the agent. Whether all forms of accountability necessarily reduce the independence of the agent is a contentious issue.⁵ Some authors argue that they are inversely related, others contend that they are linked but not in a strict inverse relationship. Yet some others think that they are separate concepts.

For sure the two concepts can be defined both as distinct and as inter-related. For the purposes of this paper, we understand independence to be a description of the universe of all possible actions/decisions, and accountability to be a determinant of the choice of specific actions within that universe. In other words, independence delineates boundaries and accountability leads to selection of particular actions within those boundaries. It is

⁵ See Scholten, Miroslava, *Accountability vs. Independence: Proving the Negative Correlation*, *forthcoming*, *Maastricht Journal of European and Comparative Law*, 2014, and references therein.

possible that certain accountability mechanisms or arrangements may restrict the universe of possible options and therefore end up curtailing the independence of the agent and vice versa. The “art” in the delegation of tasks is to find an arrangement whereby the agent is accountable without his independence being excessively curtailed.

Over time, however, the principal learns from the results of the decisions and actions of the agent. That is, the actions of the agent reveal information about his ability to achieve what the principal wants. This means that the principal-agent relationship is dynamic and evolves over time. Both the principal and the agent will, of course, take the revealed information into account, the principal *ex post* and the agent *ex ante*.

The next section uses a simple model to formalise the relationship between the principal and the agent in order to identify how an accountable agent is likely to behave and what is the best approach for the principal who can determine the boundaries of the agent’s independence and the accountability mechanisms to which the agent is subject and can take into account learning effects over time.

A simple model of accountability and independence

In the typical principal-agent formulation, there is a component of the agent’s work which is observable and a component which is not.⁶ For most principal-agent relationships the non-observable component is the most important element that affects the outcomes produced by the agent. In the case of ESMA, this does not appear to be very significant because, given its regulatory function, it must make public all the rules it devises and enforces. Moreover, as explained later on, ESMA has to consult its principals before it acts. Hence, there is no major problem in observing ESMA’s actions. However, there is still a problem in motivating ESMA to be innovative and devise rules that can prove effective in pre-empting and remedying market malfunctions. Consultation can prevent ESMA from acting, but cannot force it to act and, for sure, it can hardly make it more innovative. Since in designing and enforcing financial regulation pre-emption is important, inaction [i.e. under-regulation] can be as problematic as excessive action [i.e. over-regulation]. In addition, and perhaps more importantly, outsiders do not observe the internal costs of ESMA. These are not the accounting costs of ESMA’s functions, which are probably well-known to its principals. Rather they are the costs associated with effort, managerial supervision, staff motivation, etc. Certainly, these internal costs exist in all organisations, also for ESMA and they do have an impact on ESMA’s performance. We consider their impact immediately below.

⁶ There is also a component that is neither observable, nor definable *ex ante*. This component is made up by the internal characteristics of the agent such as ingenuity, intelligence, tenacity, etc. They very much influence the final outcome but cannot be meaningfully measured.

We assume that ESMA is a rational agent that wants to minimise the costs it bears from its operations. This is its objective function. Let's indicate the costs borne by ESMA by its own actions as C . C is a function of x which is a measure of the regulatory effort of ESMA; i.e. $C = f(x)$. Further assume that because some effort is both observable and measurable, it can be fixed in advance so that the agent is forced to exert a certain minimum effort. The function C becomes then $C = f(e' + x)$ where e' is the minimum required effort and x is extra effort. In Figure 1, function C is simplified by assuming that it takes the form $C = \beta(e' + x)$ [a straight line]. The horizontal axis starts at e' .

The ideal situation for the principal is when the agent exerts as much effort as necessary to reach the best possible outcome. Since in the case of ESMA the desired outcome is defined only in terms of general policy targets, the principal focuses on the effort exerted by ESMA. In general, the more effort exerted by ESMA the better. As explained later on, the regulation that establishes ESMA and the regulation on short selling impose on it certain obligations to regulate or, in our terms, to act. This can be thought of as one of the accountability mechanisms that apply to ESMA.

Let's assume that the principals of ESMA define the accountability mechanism in a way that reflects the gains to society from ESMA's regulations. We can think of it as corresponding to the social opportunity cost from ESMA inaction. Therefore, if ESMA does not exert additional effort, social costs are high, but as ESMA acts, costs decline. We can now consider how this impacts on ESMA. The accountability mechanism can reasonably be presumed to be designed in such a way so that it also creates costs for ESMA [i.e. inaction is costly for ESMA].

If the opportunity cost of society is given by a function A , then we can surmise that the accountability mechanism is such that a proportion of A , i.e. αA , reflects the costs borne by ESMA. It is assumed that A is convex so that $dA/dx < 0$ and that $d^2A/dx^2 > 0$. That is, as ESMA exerts more effort, the costs of these obligations decline but at a decreasing rate. Obligations imposed on ESMA make it accountable because it is costly for it not to fulfil them. Although inaction is costly, excessive action is costly too because after a point [shown by x'' in Figure 1], function A curves upwards. Since we already assume that the principals do not have a perfect accountability mechanism (at this point $dA/dx = 0$), the costs [which are a proportion of the opportunity cost of society] do not decline to zero. The principals are never sure that ESMA action resolves all market problems or that it is even theoretically possible for ESMA to resolve all problems [so they always face some opportunity cost]. For the principals there are two distinct sources of information: the market and ESMA. The problem is that the information is mixed up.

The objective of ESMA is to find an x such that it minimises the total cost, T , of effort and accountability. That is, it minimises $T(C, A) = C(x) + A(x)$. The optimum x for ESMA is at x^*

where $dC/dx = -dA/dx$. This is shown in Figure 1 where x^* is at the point where total cost T is at its lowest level. It is important to note is that if functions C and A have linear and convex shapes, respectively, then there will always exist a minimum. ESMA will not want to move beyond x^* , nor will it want to stay below x^* .

Incidentally, it is worth noting at that point that a regulator in the situation described here would experience economies of scale because for certain values of x , function T is downward-sloping. More formally, if we raise respectively the cost of ESMA own actions and the opportunity cost for the society by a constant term γ , the resulting total cost function satisfies the inequality $T(\gamma C, \gamma A) < \gamma C(x) + \gamma A(x)$.

These economies of scale also suggest that a single regulatory authority is a more efficient arrangement, *ceteris paribus*, than a system with multiple authorities [of course, there is also the problem that a system with multiple authorities and overlapping jurisdictions would create confusion and enforcement conflicts]. On the other hand, the existence of multiple authorities allows their principals to compare their performance. In our model we do not formally analyse interaction between multiple regulators. However, we will return to this issue in the section where we assess the ESMA judgment.

To summarise so far, our simple model shows that it is the accountability mechanism that induces the agent to act, not the extent of his independence. Limiting independence, limits the options of the agent but does not incentivise the agent either to exert more effort or to choose any particular option. If the above simple reasoning holds, then ESMA has a strong incentive to be active in devising and enforcing regulations. Accountability mechanisms that penalise inaction do indeed induce ESMA to regulate. In practice, the essential question is whether the regulations that are certain to come out of ESMA are such that they can achieve the objective of preventing and remedying market failure.

In the next section we explore in more detail the interaction between the principal and agent over time, as they may take into account learning effects and then we consider the implications for ESMA and the EU.

Inter-temporal interaction

As shown in the previous section, there is a natural tendency for an accountable agent to act. Therefore, the principal should worry more about binding constraints on the independence of the agent. Figure 1 can help us understand the impact of such binding constraints.

For whatever accountability mechanism that is used, the agent must have sufficient independence to exercise additional effort. If the constraints on the independence of the agent prevent him from reaching x^* then they are binding. If they become binding only for a value of x such that $x > x^*$, then they are not binding because the agent would never voluntarily exert effort larger than x^* . This means that the natural tendency of the agent to be active, but not excessively active, implies that the principal should be concerned about the negative impact of too little independence rather than too much independence [for whatever accountability mechanisms that are imposed].

Figure 1 also shows a boundary at x^\wedge imposed by the principal on the actions of the agent. The boundary is never reached by the agent because $x^* < x^\wedge$. In this model, boundaries are not effective in inducing the agent to get closer to x'' [which is the value such that $d(\alpha A)/dx = 0$ and it is the optimum of the principal because it minimises society's costs from market instability].

If the boundary that is shown in Figure 1 is an upper boundary, one may think that the solution is to impose a lower boundary to force the agent to move to the right. But if accountability mechanisms apply only within the limits of the boundaries of the agent [i.e. the extent of the agent's independence] and if they have the shape that is postulated here, it is likely that x^* and x'' will get closer to each other, but will not coincide. After all, Figure 1 also has a lower boundary. It is the vertical axis at e' .

Figure 1 can help us gain some insight into the nature of the trade-off between the independence of the agent and his accountability. By compressing the lower and upper boundaries and by limiting the distance between them, the optimum of the agent, x^* , gets closer to the optimum of the principal, x'' . But this assumes that the principal has a pretty good idea of the value of optimum action by the agent. If he does not, then he risks limiting the options of the agent to a range of x that may be far from the real x'' . If the principal does not have the prerequisite prior knowledge, the boundaries must be wider apart, which also increases the distance between x^* and x'' . Ex ante ignorance entails that many possible values of x are admissible.

Now, let's inject a bit of complexity. The section on the nature of accountability was concluded with the suggestion that both the principal and the agent learn over time. It is therefore reasonable to assume that the principal would expect the agent to internalise these learning effects. An accountable agent must be an agent who is capable of learning and adjusting, but non-adjusting agent must also be accountable. Indeed accountability can be thought to imply that the agent has to justify why he chooses to ignore important information that is relevant to the attainment of the objective set by the principal.

But this creates a problem for the agent in the following sense. Assume that the principal and the agent interact in two periods, 1 and 2. Figure 2 shows two sets of functions, T and A, for period 1 in solid lines and for period 2 in intermittent lines. It also shows a lower boundary of x , at x^{\sim} . If in period 1, x^{\sim} is exceeded then in period 2, the principal pushes the A function to the right because he expects more effort from the agent. It is as if the principal pushes the lower boundary from e' to x^{\sim} . If the agent minimises his costs in period 2, the optimum effort is given by x_2^* . But T_2 at x_2^* is higher than T_1 at x_1^* . Therefore, the agent has a strong incentive not to minimise costs in period 1 because x_1^* exceeds the threshold value of x^{\sim} . Therefore, he wilfully underperforms and stays at x_1 in order not to give a signal to the principal by exceeding x^{\sim} .

We now have to adjust our previous conclusions. If there is no learning then ESMA will actively regulate. However, in a dynamic context where learning occurs, ESMA may have an incentive to underperform so as to jam the signals to the principal.

The principals of ESMA, like any principal who interacts inter-temporally with an agent, have to devise ways of assessing the performance of ESMA, not simply by observing the outcome of its actions but, in addition, by forming expectations as to its future performance and outcomes.

There are several ways they can form expectations about future performance. They can predict performance on the basis of theoretical models. This is akin to asking how another agent or a typical agent would act in the same situation. Or they can empirically observe what other agents actually do in similar situations. Both the theoretical and empirical method in fact establish a benchmark of what can be reasonably expected. But whatever they choose to do, there are consequences for both the principal, who has to exert more effort in control activities, and the agent, who has to work harder.

This situation can be modelled as a game where two players, a principal and an agent, may respectively choose to control or trust and to work or shirk. This can be shown in terms of payoff values expressing the return for ESMA and the EU. Let's assume the following payoffs which take into account possible accountability mechanisms:

For ESMA: +2 if it works hard without being controlled by the EU; +1 if it works hard but under the control of the EU; +3 if it shirks without being controlled and -1 if it shirks but it is controlled by the EU.

For the EU: +3 if ESMA works hard without having to control it; and +2 if ESMA works hard but only when the EU controls it; -2 if ESMA shirks without any control and -1 if ESMA shirks but it is controlled by the EU.

The situation just described is represented in payoff matrix in Table 1:

Table 1

	EU	T	C
ESMA			
W		2,3	1,2
S		3,-2	-1,-1

With these payoffs, there is no dominant strategy that can form a Nash equilibrium. If the EU trusts, then ESMA will choose to shirk. If the EU controls, ESMA will work. The same applies to the EU. If ESMA works, the EU will trust it. If it shirks, the EU will control it.

However, we can determine the probability p of trusting and controlling that can generate the same payoff for the principal (i.e. the EU). This results from equalising the payoffs from choices T and C to have the same expected returns from trusting ESMA actions or from deciding to check the outcome produced, i.e.

$$3p - 2(1 - p) = 2p - (1 - p) \Rightarrow p_{EU} = \frac{1}{2}$$

Therefore, in a context where the principal and the agent learn over time from past actions, if the EU succeeds to convince ESMA that there is a 50% chance of being checked for its behaviour, this will result in the same welfare gain irrespective of whether the EU actually decides to exercise its control or not.

Indeed, if we consider the probability q of working or shirking that can generate the same payoff for the agent, then

$$2q + (1 - q) = 3q - (1 - q) \Rightarrow q_{ESMA} = \frac{2}{3}$$

The agent is more likely to work.

This result shows that we can design an institutional framework in which the EU can allow the agent to accomplish its duties independently, as long as the agent credibly considers the possibility that it can be asked to justify its actions or that it can be assessed through other means.

More generally, we can also see this as a coordination game in which the parties can realise gains by making mutually consistent decisions over not only the type of actions but also the two minimum levels of effort x (generic) and x^{\sim} . In this case both the principal and the agent obtain joint benefits in, respectively, trusting and exerting high level of effort at the same time.

We can assume this situation to be described by a pay-off structure of the following form:

Table 2

	EU	T	C
ESMA			
W		1,1	0,0
S		0,0	x, x^{\sim}

With $0 < x^{\sim} < x < 1$.

In Table 2 we see that neither the principal, nor the agent derive any gain from having non-coordinated decisions. Both of them bear the burden from lack of coordination. If the agent chooses to work and the principal to control, since the agent carries out his duties, the principal wastes resources in checking the agent. The agent also suffers a loss because of the control exerted by the principal over his actions. If the principal chooses to trust and the agent to work or the agent shirks and the principal controls, then in the first case they obtain the highest payoffs [they are assumed to be equal for both players] while in the second case the payoffs are equal to the two minimum thresholds of effort x and x^{\sim} . This outcome is undesirable because payoffs are lower than in the case where the principal and the agent avoid waste of resources by coordinating their behaviour.

In a static coordination game where both the principal and the agent take decisions at the same time having all possible information about the other player's payoffs - with the highest payoffs occurring when they choose the same strategy - there are two possible equilibria. One would be characterised by the choice of working for the agent (W) and trusting for the principal (T), and the other by the choice of shirking (S) and controlling (C). However in a static framework we are not able to say which one is more likely to occur. Nevertheless we can consider a dynamic framework to show what would happen where both the principal and the agent do not know which choice of the other player will actually take place.

Considering the pairs of choices working v trusting and shirking v controlling , it is possible to determine the probability such that both the EU and ESMA have the same expected gain irrespectively of which pair is actually chosen. This can happen in relation to the probability of being indifferent in terms of pay-off between their choices.

Starting from the agent and assuming both his choices as equally likely to happen, these have to be both best responses to the principal's probabilities of trusting and controlling, respectively p and $1 - p$, in order to make the agent indifferent between working and shirking. The same applies to the principal in terms of the probability q that the agent is willing to commit himself to work.

More formally this will be such that – for the agent – the expected payoffs of working and shirking in terms of the probabilities (p and $1 - p$) of trusting and controlling are equalised. For the principal instead this will be in terms of the agent's probabilities of working and shirking (q and $1 - q$) , i.e.

$$\text{ESMA:} \quad p = (1 - p) x$$

and

$$\text{EU:} \quad q = (1 - q) x^{\sim}$$

Which lead to the equilibrium probabilities :

$$p_{EU} = \frac{x}{1+x} \quad \text{and} \quad q_{ESMA} = \frac{x^{\sim}}{1+x^{\sim}}$$

These reflect how likely the agent and the principals are to be indifferent between their choices. More specifically this means that in order to make the principal indifferent between controlling and trusting, ESMA will have to choose to work with a probability $q = \frac{x^{\sim}}{1+x^{\sim}}$ and conversely to shirk with $1 - q = 1 - \frac{x^{\sim}}{1+x^{\sim}} = \frac{1}{1+x^{\sim}}$. ESMA instead will be indifferent between working and shirking if the principal chooses to trust with a probability $p = \frac{x}{1+x}$ and to control for $1 - p = 1 - \frac{x}{1+x} = \frac{1}{1+x}$.

This can be represented using Table 2 as follows:

		p	$1 - p$
		$\frac{x}{1+x}$	$\frac{1}{1+x}$
		EU	T
		ESMA	C
q	$\frac{x^\sim}{1+x^\sim}$	W	1,1
$1 - q$	$\frac{1}{1+x^\sim}$	S	0,0
			x, x^\sim

It is interesting to note that in this case a larger minimum level of effort, x and x^\sim , does not result in a larger probability of the agent to choose to shirk, and for the principal to control. Conversely, this would simply denote a change in the probability of being indifferent between the two actions. This means that, again, enforcing a certain (higher) level of effort by the agent does not necessarily produce better results, particularly considering the (higher) cost borne by both parties for this enforcement. An increase in the minimum threshold of required effort might indeed simply cause the agent to strictly commit to this minimum level refusing to perform any better, in turn lowering dramatically any chances for the principal to observe an effort above the threshold. This is also because increasing the minimum level of effort demanded will only increase the indifference between the pairs of choices, without really affecting the likelihood of any of them to occur.

This situation is represented graphically in Figure 3 where the ESMA best response functions for the two choices (W, S) and (T, C) are shown in terms of the probability p and q of realising the same gains in both cases. In the first sequence of graphs this is done for the agent on the left hand side in terms of the utility resulting from the level of effort x and the probability p and $1 - p$ associated to the principal's choices (T, C). This results into the best responses representing the agent strategies that produce the highest payoff given what the principal is doing. The intersection of the two best response functions gives the Nash equilibrium of this game where nobody can receive a greater pay-off from changing actions (i.e. deviating unilaterally), assuming the other player maintains his strategy.

Looking at the agent's utility in choosing to work when the principal might decide to trust his actions with a probability p , the expected payoff is simply equal to this very same probability, i.e. $u(W, p) = p$. On the other hand the expected payoffs associated to the agent's choice of shirking results into a utility level $u(S, p) = (1 - p)x$. In this latter case if the principal chooses to trust with a probability p equal to zero this delivers a payoff equal to x

(with $0 < x < 1$) , whereas if p instead equals 1 then the level of effort as well as the associated payoff becomes null.

The graph on the right hand side repeats the same analysis for the principal's choices (T, C) this time considering the minimum level of effort desired x^{\sim} and the probabilities q and $1 - q$ associated to the agent's choices (W, S). In this case everything is analogous to the previous one, just the intersection of the two curves happens earlier along the horizontal axis since $x^{\sim} < x$.

The second series of graphs instead simply maps this situation in terms of the probabilities p and q associated respectively to the choices (W, S) and (T, C). This is done looking at the best responses for both choices represented in the previous graphs. Considering the agent's utility for (W, S) we can see as the choice of shirking delivers a higher outcome for a probability $0 < p_S < x/x+1$. On the other hand working is better for $p_W > x/x+1$, whereas the agent is indifferent in terms of the two choices if $p_W = p_S = x/x+1$. The same logic applies to the principal's utility resulting from the pair of choices (T, C).

Furthermore, it is also possible to introduce an incentive mechanism to induce both the agent and the principal to coordinate their choices over the decision of respectively working and trusting. For this to happen it's enough to increase either the payoff of ESMA in case he commits to work and the principal runs a check over his actions or the one of the principal in the unhappy case where he trusts the agent and the latter chooses to shirk – as if a compensation for the agent's inefficiency was introduced.

The new payoff structure just described is represented below:

Table 3

	EU	T	C
ESMA			
W		1, 1	x, 0
S		0, x	x, x^{\sim}

From Table 3 we can see as now the principal's probability of trusting that could induce ESMA to prefer to commit to a high level of effort is such that it makes the expected gain from working greater than the one from shirking, i.e.

$$p + (1 - p) x > (1 - p) x$$

So to have:

$$p > 0$$

Hence the simple introduction of an incentive for the agent to commit even when the principal checks his action is enough to motivate him to perform at its best. Indeed for the principal is now sufficient to be even slightly likely to trust (in fact whatever $p > 0$ is enough) to have the agent willing to provide high levels of effort rather than shirking. As said before an analogous result could then be showed in terms of the agent's probability q that could induce the principal to be more in favour of trusting rather than controlling, provided that a compensation for the agent's inefficiency is offered in case the latter chooses to be unproductive.

Therefore, in order to achieve a better outcome with reduced costs, it is not enough for the principal to implement a credible and effective accountability mechanism. He also needs to resist the temptation of adapting it too often or making it too strict because this would, on the one hand, raise the costs connected to the regulatory process and, on the other, he reduce the value of the outcome delivered by the agent. The latter in fact needs to be granted some independence to exert effort higher than the minimum requirements to perform its standard tasks. It is also necessary to have a framework where both the principal and the agent can learn from their past actions to finally arrive at a stable equilibrium where as a result of a dynamic process, the decisions of both sides converge towards the welfare maximising choices for the whole society.

Before turning to the actual ESMA judgment, it is useful to summarise the main points of the analysis so far. They are as follows:

- i) If the results that are desired by the principal cannot be fully described ex ante, then the agent needs to enjoy a certain degree of independence.
- ii) In order to ensure that independence is not abused, the agent also needs to be accountable.
- iii) There is a trade-off between independence and accountability in the sense that constraining the choices of the agent also make him accountable/responsible for fewer possible outcomes.
- iv) The principal should be concerned about the effectiveness of accountability mechanisms.
- v) The agent has an incentive to be active but will not try very hard, if he incurs costs. In a dynamic setting the agent may wilfully underperform so as to jam signals to the principal.
- vi) The principal needs to have a benchmark to assess the actual performance of the agent. The benchmark is the expected performance of a typical agent, if such an agent can be identified theoretically or empirically.
- vii) Under conditions of imperfect information about desired market outcomes and about the true ability of the agent, accountability in the form of ex post assessment of

performance is probably more effective than in the form of ex ante control of the agent's choices.

viii) Any form of control by the principal is costly for both the principal and the agent. It is in their long-term interest to cooperate whereby there is neither excessive control, nor shirking.

ix) It follows that the control by the principal and the accountability of the agent are activities that evolve over time.

The ESMA case

On 22 January 2014 the Court of Justice of the European Union rendered its judgment in case C-270/12 concerning an action for annulment brought by the UK against the European Parliament and the Council of the EU.⁷

The UK sought annulment of Article 28 of Regulation 236/2012 on short selling and certain aspects of credit default swaps⁸. This Article confers on the European Securities and Markets Authority [ESMA] certain powers which, according to the UK, contravened the "Meroni doctrine". Regulation 236/2012 itself was adopted on the basis of Article 114 TFEU for approximation of laws necessary for the functioning of the internal market.

Under Article 28 of Regulation 236/2012 ESMA may i) require natural or legal persons who have short positions in relation to a specific financial instrument to notify a competent authority or disclose details of any such position; or ii) prohibit a short sale which relates to a different financial instrument where a financial advantage is obtained in the event of a decrease in the price of another financial instrument.

Furthermore, ESMA may act only if i) there is a threat to the orderly functioning and integrity of financial markets or to the stability of the financial system and ii) no competent authority has taken measures to address the threat.

Article 28 also requires ESMA to take into account the extent to which its measures i) significantly address the threat to the orderly functioning and integrity of financial markets and the stability of the financial system, ii) create a risk of regulatory arbitrage, iii) have a detrimental effect on the efficiency of financial markets.

⁷ The actual text of the judgment can be accessed at:

<http://curia.europa.eu/juris/document/document.jsf?text=&docid=146621&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=54936>

⁸ Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps OJ L86, 2012

Before deciding to impose or renew any measure, ESMA must i) consult the European Systemic Risk Board [ESRB], ii) notify the competent authorities concerned. The notification must include evidence supporting the reasons for those measures.

Lastly, ESMA must review its measures at appropriate intervals and at least every 3 months. If a measure is not renewed by the end of a three-month period, it automatically expires.

Subsequently, the Commission in Delegated Regulation 918/2012 defined in more detailed the circumstances in which ESMA could decide to take action. Furthermore, in Implementing Regulation 827/2012, the Commission laid down technical standards with regard to public disclosure and provision of information mentioned in Article 28.

The judgment

The UK claimed that there was a breach of the principles relating to the delegation of powers, as laid down in case 9/56, *Meroni v High Authority*⁹, because ESMA had “a very large measure of discretion”. More specifically, it thought that whether there was a “threat” to the orderly functioning and integrity of financial markets, or to the stability of the financial system was a “highly subjective judgment” which would lead ESMA in the “implementation of actual economic policy and require it to arbitrate between conflicting public interests, make value judgments and carry out complex economic assessments.” In addition, ESMA had “extremely wide-ranging discretion when deciding how to take account of the factors set out in Article 28”.¹⁰ Such decisions would be “highly subjective”, would “require an analysis of the significant economic policy implications” and would result in “unquantifiable judgments”. [paragraphs 28-34 of the judgment]

The Court began its assessment of the main plea alleging breach of the *Meroni* doctrine by identifying the relevant issues of the *Meroni* case. “The consequences resulting from a delegation of powers are very different depending on whether it involves clearly defined executive powers the exercise of which can, therefore, be subject to strict review in the light of objective criteria determined by the delegating authority, or whether it involves 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’. [paragraph 41]

“A delegation of the first kind cannot appreciably alter the consequences involved in the exercise of the powers concerned, whereas a delegation of the second kind, since it replaces

⁹ Cases 9/56 and 10/56, *Meroni & Co, Industrie Metallurgiche v. High Authority*, [1957-1958] ECR 133.

¹⁰ For more on decision-making powers by the European Financial Supervisory Authorities: E. M. Busuioc, M., *Rulemaking by the European Financial Supervisory Authorities: Walking a Tight Rope*, (2013) *European Law Journal*, 19(1): 111-125.

the choices of the delegator by the choices of the delegate, brings about an ‘actual transfer of responsibility’. As regards the case which gave rise to *Meroni v High Authority*, the Court held that the powers delegated by the High Authority to the bodies in question ... gave those bodies ‘a degree of latitude which implied a wide margin of discretion’, which could not be considered compatible with the ‘requirements of the Treaty’.” [paragraph 42]

In other words, the exercise of a wide margin of discretion by the bodies to which powers are delegated is incompatible with EU law.

Then the Court turned its attention to the functioning of ESMA. It noted “that Article 28 does not confer any autonomous power on that entity that goes beyond the bounds of the regulatory framework established by the ESMA Regulation.” [paragraph 44]

It went on to observe that “unlike the case of the powers delegated to the bodies concerned in *Meroni v High Authority*, the exercise of the powers under Article 28 of Regulation No 236/2012 is circumscribed by various conditions and criteria which limit ESMA’s discretion.” [paragraph 45]

It listed the following constraints on ESMA’s discretion [paragraphs 46-50]:

1. ESMA can adopt measures only if they address a threat to the orderly functioning and integrity of financial markets or to the stability of the financial system in the Union and there are cross-border implications.
2. All ESMA measures are subject to the condition that no competent national authority has taken measures to address the threat.
3. ESMA is required to take into account the extent to which a measure i) significantly addresses the threat to the orderly functioning of financial markets or to the stability of the financial system, ii) does not create a risk of regulatory arbitrage and iii) does not have a detrimental effect on the efficiency of financial markets.
4. ESMA is required to consult the ESRB and must notify the competent national authorities concerned of the measure it proposes to take, including evidence supporting the reasons why it must be adopted.
5. ESMA is also required to review the measure at appropriate intervals.

The Court concluded that ESMA’s “margin of discretion was circumscribed” by both the consultation requirement and the temporary nature of the measures authorised, which were “established on the basis of best current practice in the field of supervision”

[paragraph 50]. It is not clear how the Court reached the conclusion that ESMA relied on “best current practice”. At any rate, the Court also considered that there was a “detailed delineation of the powers of intervention available to ESMA”. [paragraph 51]

On the basis of the above reasoning, the Court found that ESMA’s powers were in compliance with the Meroni doctrine and that “those powers do not, therefore, imply that ESMA is vested with a ‘very large measure of discretion’ that is incompatible with the FEU Treaty”. [paragraph 54] That is, having powers is not equivalent to having discretion, as long as, according to the Court, the powers are precisely delineated.

There were several other pleas all of which were rejected by the Court leading it to dismiss in its entirety the UK action.

Assessment of the ESMA judgment

When seen within the confines of the particular circumstances of ESMA, the judgment¹¹ is evolutionary rather than revolutionary. It is evolutionary in the sense that the Court has recognised explicitly, most probably for the first time, that an agency that wields significant powers does not necessarily enjoy a wide margin of discretion. This is because it may be possible for the principal, i.e. the EU, to delineate the powers it delegates to it so that they leave little room for discretionary action by the agency¹².

The question that arises is, of course, whether the powers of ESMA are indeed sufficiently delineated so that its discretion is actually curtailed. In answering this question, we need to start from one of the conclusions of the Court of Justice which in paragraph 116 of its judgment acknowledged that “the purpose of the powers provided for in Article 28 of Regulation No 236/2012 is in fact to improve the conditions for the establishment and functioning of the internal market in the financial field.” Since ESMA had been assigned such a broad responsibility, then we can put forth the following arguments with regard to the judgment.

First, as shown by the theoretical analysis in previous sections, the problem is not inaction, since the presence of effective accountability mechanisms suffice to push the agent towards a minimum level of effort every time. Therefore, the fact that ESMA is required to consult will not curb its natural tendency as an agent to act. Since it would want to act, it would also consult. ESMA apparently is not prevented from acting when it receives negative advice at consultations.

¹¹ Case C-270/12, United Kingdom v Parliament and Council, [2014].

¹² For more on the delegation of powers to the agencies: Hart, Oliver, and Bengt Holmström. “The theory of contracts”. Department of Economics, Massachusetts Institute of Technology, 1986.

Second, as also concluded in the theoretical discussion, the challenge for the principal is not to impose too many constraints on the agent. Rather the principal should want to confer wide discretion but at the same time subject the agent to effective accountability, which is possible as long as the right incentives are employed. As pointed out before, it is neither realistic, nor rational to expect ESMA to resolve all market problems which formally come under its purview, given the existence of opportunity costs and incentive constraints. Perhaps no authority would be willing to give a negative advice for fear that it may be blamed in case market conditions deteriorate.

Third, apart from the broad obligation of ESMA to justify its actions, and show that they are intended to remedy market failure, and its obligation to consult nothing else appears to limit the substance of its decisions. So its powers may not be effectively circumscribed. Given that neither perfect accountability, nor effort maximisation are realistically achievable, the EU must be forward looking and take into account the dynamic nature of the principal-agent relationship. This suggests that in the case of agencies such as ESMA, ex-post assessment of their performance is as necessary as ex ante obligations.

There are also other aspects of the judgment that detract from its quality. First, the Court mixes up the limits on ESMA's discretion, what ESMA is allowed to do and how long it is allowed to do it [i.e. the extent of its independence] with how ESMA is required to consult, explain and justify its decisions and the measures it adopts. [i.e. the extent of its accountability].

Second, the Court does not consider, and indeed appears to be unaware, that effective exercise of the powers to safeguard the stability and integrity of the financial system necessarily implies that ESMA must enjoy a degree of independence that cannot be fully circumscribed in advance. It is simply impossible to draw up an exhaustive list of the threats to the stability and integrity of the financial system and the corresponding remedial action that should be undertaken in each eventuality by ESMA. The UK is right that ESMA will have to make subjective and judgmental calls. Therefore, for ESMA's principals the question is whether they have effective means to evaluate the quality of those judgment calls.

Third, the Court does not consider at all whether the accountability mechanisms to which ESMA is subject are sufficient to curtail its margin of discretion. If, as the UK claims, ESMA will have to carry out complex economic analysis, how will the EU, the ESRB, and the Member States be able to contend that ESMA has breached its powers? This is the issue mentioned above about evaluating judgmental calls.

Fourth, too little regulation is as much a problem as excessive regulation. In other words, the Court does not examine whether ESMA may in fact abuse its margin of discretion by not

being active enough. This would mean that ESMA would not regulate and therefore it would not need to consult. But inaction is also a problem [because it does not remedy market failure] and Member States need to have other ways of assessing whether ESMA acts correctly by not intervening.

Fifth, and more broadly, the motivation behind the independent regulators that have been established across industrial countries during the past two decades is to concentrate technical tasks in single, sector-specific authorities so that the quality of their decisions improves with experience while at the same time insulating them from political intervention. Indeed, the financial crisis has shown that when markets move erratically, regulators need to act not only fast, but also decisively, in unusual and innovative ways and without heeding much attention to the transient concerns of the government of the day. As argued at several points in this paper, it defeats the purpose of delegating policy or enforcement responsibility to specialised agencies if their discretion is subsequently circumscribed through too many external controls. This clearly raises the need for different measures which can also be implemented at a lower cost. As it has also been shown, it is possible to design a framework where both the agent and the principal find it beneficial to cooperate over time.

The Court of Justice does not seem to recognise that the Meroni doctrine has become obsolete as far as delegation of regulatory tasks in financial markets is concerned.¹³ Of course the judgments of the Court always depend on the issues raised by the various parties and the arguments in law that they make. The Court cannot normally deal with issues not raised by the parties.

However, it could have examined whether ESMA had to enjoy a certain degree of discretion in order to carry out effectively the tasks assigned to it. The Court could have also assessed the quality of the accountability mechanisms to which ESMA is subject and how Member States could evaluate the soundness of ESMA's decisions and regulations.¹⁴ They would afford the agent sufficient independence since they would not impede his actions before or during the regulatory process, but they would also ensure that the agent remains accountable for the results of his decisions with ex post evaluations and peer assessments.

¹³ J. Pelkmans and M. Simoncini, *Mellowing Meroni: How ESMA can help build the single market*, CEPS Commentary, 18 February 2014, argue that Meroni has to be relaxed in relation not just to financial markets but all network industries.

¹⁴ For more on the relations between the agencies and EU Member States: M. Everson, C. Monda, E. Vos, *EU Agencies in between Institutions and Member States*, Wolters Kluwer (2014).

Conclusions

This paper has reviewed the recent judgment concerning ESMA in the context of the principal-agent theory. In this context the degree of accountability and the extent of independence of the agent have a decisive influence on the behaviour of the agent.

Because financial regulation is not like baking pizza, regulators must necessarily enjoy a certain degree of independence which, however, has to be counterbalanced by accountability mechanisms such as an obligation to explain and justify regulatory measures.

The ESMA judgment does not appear to recognise the need for regulators to be able to act with at least some independence and to wield at least some discretion.

Moreover, the judgment does not examine in any detail whether and how the principals, i.e. the EU and Member States, are best able to evaluate the quality of ESMA decisions and regulations and whether there are different accountability mechanisms of higher degree of effectiveness.

Figure 1
Effort, costs and accountability of the agent

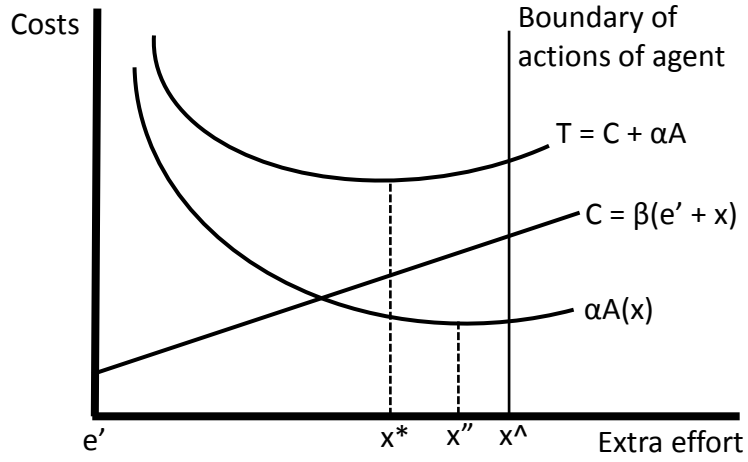


Figure 2
Effort and learning over time

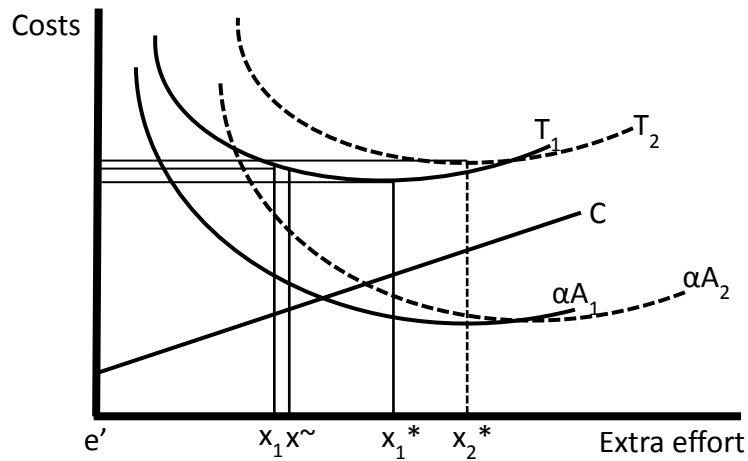
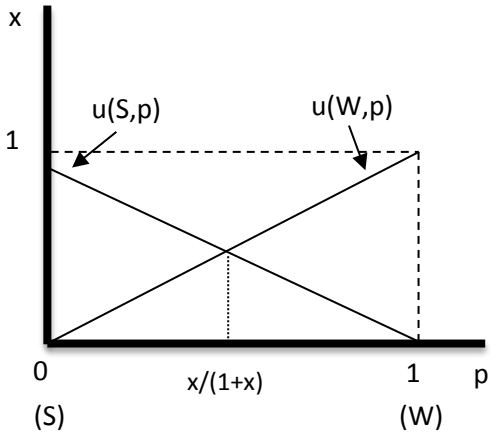


Figure 3
Best response functions in a coordination game

ESMA



EU

