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Market Transparency – Does it prevent crisis?

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Ladies and Gentlemen,

Good morning. It is my great pleasure to be here today at this important conference and I thank the Austrian Financial Market Authority for their kind invitation.

We are living extremely difficult and delicate times that request from anyone responsible behaviours and actions to find a rapid solution to the problems that affect our markets, our economies, our societies. ESMA, within the limits of the powers assigned to it and the limits of an organization that is in the midst of building its regulatory and supervisory capacity is doing its part and we are deploying all our efforts to ensure efficiency, integrity and good functioning of financial markets. I hope this conference, and the debate on the key topics emerging from the crisis, will also contribute to the achievement of these objectives.

I have been asked to contribute to the topic of market transparency and its relationship with the crisis. In so doing, firstly I will explain the reasons why transparency is an essential ingredient of securities regulation and why it has been considered to be the traditional solution in response to market imperfections. I will then elaborate on the reasons why transparency is not always sufficient to achieve certain key objectives like efficiency and integrity of markets, protection of investors, and confidence in the good functioning of financial markets. Hence, as I will explain later, sometimes further regulatory interventions beyond transparency are needed. Thirdly, I will turn to identify the measures that in the current re-regulatory phase in response to the crisis will, if adopted, contribute to ensure more transparency to the public and to regulators. Finally, I will conclude with some observations on transparency and accounting.

But before sharing with you my more analytical analysis of transparency, let me update you on the more pressing issue of the current financial crisis and the role of ESMA. When this summer the financial markets became under intense pressure, ESMA significantly stepped-up the monitoring of financial market developments, and coordinated the activities of national authorities. We have extensively exchanged information with our national authorities on issues such as the resilience of trading venues and trading platforms, settlement failures and exposures to CDSs. Monitoring the resilience of trading venues and platforms was especially relevant considering the record number of transactions. The ban on net short positions adopted by mid-August by the four countries (Belgium, France, Italy and Spain) was and is coordinated by ESMA, both in terms of timing and content.

While it is not easy to be optimistic considering these difficult times, one positive lesson from the events this summer is that the new legislation which is in the final stages in the political process is of very practical use to respond to a financial crisis. For example, I am convinced that we can much better coordinate the actions of national authorities when the short selling regulation is in place, and acquiring information on OTC derivatives like CDSs, will be faster and more complete when the EMIR regulation is adopted. This summer we still had to work without these important pieces of legislation.

The case for market transparency

From an economic perspective transparency has been traditionally identified as the key and basic solution to ensure good functioning of financial markets. I think there is no need to elaborate on this obvious statement, also given the fact that extensive academic research has shown that information asymmetries can be addressed with more transparency. Typically information asymmetries are considered to exist when the relationship between two or more parties - either entering into a contract or not - is uneven and one possesses more information than the other(s). Information asymmetries generate conditions of potential unfair treatment and abuses that have to be addressed with regulatory intervention to restore conditions of parity and fairness.

Some examples can be drawn from the obligation to disclose immediately price sensitive information to the public, transparency of financial performance and positions by debtors (and particularly issuers) by imposing disclosure of financial statements, transparency about trades executed or to be executed, and disclosure of conflicts of interest. Asymmetries in information positions are evidently more pronounced when professionals are dealing with non-experienced persons, such as retail investors and consumers, but they also exist between financial counterparties having similar experience or capacity. This is the reason why the need for transparency is imposed rigorously by public regulation in the general public interest as an instrument to enhance market efficiency.

Having said that transparency brings overall benefits to the market, improving its efficiency and good functioning and ultimately contributing to financial stability, we may argue that the market should have sufficient incentives to develop, adopt and implement measures to foster market transparency. However, opacity favours and benefits the individual positions of market players, allowing exploitation of information asymmetries. Therefore, this is a typical situation where decisions adopted in the general interest benefit all players, but, individually, there are not sufficient incentives to move ahead alone.

Given the lack of sufficient and credible steps made by market led initiatives of a self regulatory nature, transparency is an area where regulators had and have to intervene in the general public interest to restore conditions of adequate levels of transparency to reduce the information gaps and ensure good conditions of market functioning.

Transparency, but not only...

Transparency represents the first layer of securities regulation. It is also the basic form of regulatory intervention since it is relatively straightforward to be implemented and it is not too burdensome for regulated firms. Whilst in principle it is hard to identify major drawbacks imposing more transparency, when considering the granularity of any new transparency requirement we should assess the effective needs against the costs imposed and expected benefits. We know that transparency exceptionally may entail negative consequences and also potential damages. For instance, immediate disclosure of price sensitive information may put a transaction at risk. This is the reason why the Market Abuse Directive foresees that in exceptional circumstances price sensitive information may be disclosed to the public with some delay. Hence, under strict conditions it is allowed to maintain for some time information asymmetry.

Despite the overall benefits that transparency can bring, over time, transparency has not been considered to be in itself a sufficient tool to preserve and guarantee conditions of good market functioning. The increasing complexity of business, organizations, products, transactions, strategies, and behaviours raised concerns that have requested the adoption of other regulatory interventions to supplement the mere flow of information given to the market.

Therefore, over time, securities regulation has entered into new territories, that, in the past, were typically of strict competence of prudential and competition authorities. This second layer of regulation - to remain within the scope of securities legislation - typically ranges from requirements on the internal organization of firms to conduct of business rules. These requirements are imposed either *ex ante*, via controls conducted in a registration or licence processes, or *ex post*, via on-going supervision and ultimately enforcement. Historically market players, such as financial intermediaries and portfolio managers, have been submitted to these controls. More recently, all new actors brought within the scope of financial regulation following the G20 decisions (such as hedge funds, credit rating agencies, and new market infrastructures such as CCPs and trade repositories), have been submitted to regimes similar to the ones of other financial firms. The measures proposed or adopted range from an initial assessment in the form of a registration, to on-going supervision to ensure compliance with a mix of transparency, internal control, and conduct of business rules. Of course the ideal combination of these various measures depends on the specific actor, the activity carried out and the very nature of the relationships the firm is confronted with.

When regulators and legislators are considering these more intensive measures going beyond transparency, a more demanding test should be passed before these measures are adopted. Typically, requirements regarding internal organization and the conduct of business have a bigger impact than transparency requirements.

The emergence of new regulatory responses to the crisis: enhanced transparency, but also more intrusive regulation.

A wide range of new measures have been discussed in response to the crisis: some have already been adopted, others are still under consideration. To remain in the measures falling within the securities sector, we can classify these measures again in two broad categories.

The first category is composed of new measures to foster transparency (both to the public and to regulators), either to fill existing gaps or to tighten previous requirements. The second category is, in addition to the earlier mentioned internal control requirements, composed of new measures aimed at further protecting retail investors, particularly tightening rules in the manufacturing of investment products and in the subsequent distribution phase. Let me briefly elaborate on these two categories.

ESMA is very keen to promote increased transparency in financial markets both to the public and to regulators and, when adopting new transparency requirements, will ensure appropriate calibration to avoid negative consequences and unnecessary burden on the industry.

I will not touch upon all new measures improving transparency but select a few examples.

Regarding **transparency to regulators**, one general observation that I would like to make is the relatively strong growth of information that needs to be collected by ESMA due to its new responsibilities, including ensuring stability, and the requirement to share such information with national regulators and the ESRB. The new European legislation in securities, recently adopted or under current or future negotiation, contains provisions that should ensure the achievement of these objectives.

Firstly, in the coming years the scope for transparency and its intensity will be further expanded and sharpened, particularly in areas that witnessed important growth like the market for OTC derivatives. Information overload is a danger that we have to avoid, but regulators need the necessary information to fully exercise their duties. Therefore it is expected that more transparency and reporting to regulators will be imposed to enable supervisors to monitor market developments and intervene in case of need. Lack of information would impede taking any action.

Just to mention some examples, regarding alternative investment funds, regulators will need to be provided with sufficient information on the activities of alternative investment fund managers. Regarding Credit Rating Agencies (CRAs), ESMA has just published the first draft set of regulatory standards that also contain rules on the specific content of the information to be provided to ESMA by CRAs.

ESMA also supports the maintenance and further development of regulatory transparency by suggesting extending the scope of transaction reporting to include, among others, certain OTC derivatives. In this case, trade repositories could serve as one possible channel for firms to report transactions on OTC derivatives to regulators. This would avoid duplicating the reporting requirements for firms, whilst ensuring that regulators get transaction reports on all financial instruments in the same format providing greater comparability.

We also support the introduction of mandatory client identifiers in transaction reports. Collecting this information will allow regulators to further improve market supervision, and client identifiers are much needed to be more successful in detecting market abuse cases. Finally, regarding short selling a regime of disclosure of trades to regulators is now foreseen in the current proposal for regulation.

Regarding **transparency to the public**, a first example concerns investment management. We recently published a consultation paper on policy orientations regarding ETFs and structured UCITS. This consultation followed a review of the current regulatory regime for UCITS and the conclusion reached by ESMA that the existing requirements are not sufficient considering the specific features and risks associated with these types of funds. ESMA is of the view that transparency to investors in ETFs and structured UCITS should be improved. We plan to publish the draft guidelines for consultation by the end of this year. However, ESMA is also examining possible other measures in this area, going beyond transparency. For example, issuing warnings and/or restricting distribution could be considered to mitigate the risk that particularly complex products, which may be difficult to understand and evaluate, are made available to retail investors.

A final point regarding ETFs is that activities like securities-lending, or specific forms of ETFs, such as synthetic ETFs, deserve more scrutiny from the stability point of view. This holds especially for the issue of proper collateral arrangements when ETFs are involved in securities lending and when they are engineered on the basis of derivatives.

Let's move on to another example of increased transparency to the public. After a public consultation, ESMA is currently finalizing its technical advice to the European Commission for the implementation of the directive regulating the alternative investment fund industry, the AIFMD. One of the key elements of this advice will be proposals to ensure the availability of information to investors, including information that will allow investors to better assess the risk profile of the fund. It will be important to strike the right balance between increasing investor protection while avoiding imposing undue costs on fund managers.

As regards market transparency, MiFID already includes a regime for pre- and post-trade transparency for shares admitted to trading on a regulated market, wherever the trading takes place. We support measures to enhance the quality, timeliness and consolidation of post-trade transparency data, as well as introducing a similar regime for other financial instruments such as corporate and government bonds, certain structured finance products and all kinds of derivatives including CDS. We are now waiting for the formal proposals from the Commission for the MiFID review. In post-trading, the role of trade repositories in promoting transparency of OTC derivatives markets is essential. By preparing technical standards ESMA will need to ensure that trade repositories receive the necessary information of trades and then ESMA will have to ensure that meaningful information will be available to the public without disclosing commercially sensitive elements.

As previously mentioned, the regulation on short selling and certain aspects of credit default swaps has been subject to intense negotiations in Council and Parliament in the past few weeks. If approved, it would improve transparency of short positions to the market through a requirement of public disclosure of short positions exceeding a particular threshold. The regulatory transparency would be enhanced by the requirement to report the same positions at a lower threshold to the national competent authorities. While this model for transparency for short selling, is broadly consistent with our views I would like to mention that we think that transparency to the public should not be anonymous but clearly identify the holder of the short position.

Turning now to the second category of regulatory measures, innovative tools have been envisaged, both in case of emergencies and in normal conditions when the good functioning of markets or the protection of investors is at stake.

The distribution of investment products to retail investors represents an area where more rigorous intervention is expected and innovative powers have been granted to ESMA, like the one to adopt a ban of certain activities, including the selling of categories of products. Once again, transparency has been considered to be not sufficient in ensuring investor protection. From the traditional principle of "*caveat emptor*" ("let the buyer beware") we are now experiencing innovative kinds of "product intervention" to avoid that retail investors can invest in complex and highly sophisticated products simply by imposing enhanced transparency. This is an area where practices and powers differ substantially across Europe, as is shown by an internal survey conducted by ESMA to assess the national regimes. I sincerely hope that upcoming European legislation will provide a common European basis for powers regarding product intervention.

To conclude my remarks on product intervention I would like to mention that ESMA recently established a new Standing Committee on Financial Innovation. This committee will play an important role regarding such issues as warnings for products, product intervention, and collecting data on consumer complaints.

Transparency and financial reporting

Let me now turn to some final remarks on the topics of transparency and accounting.

At the beginning of the crisis, in 2007 and 2008, a lack of transparency regarding exposures to subprime mortgages created a situation of uncertainty about the financial positions of banks. Distrust among banks caused the inter-banking credit market to dry up and interventions by central banks were requested. Efforts to impose more disclosures on the composition of portfolios of financial institutions were made to preserve the stability of individual firms, and the financial system. Additional disclosures were especially required on financial instruments related to subprime mortgages which traded in illiquid markets.

In the more recent months of the financial crisis a lack of transparency from banks on their exposures to sovereign debt and related instruments are generating new suspicions about the conditions of individual banks and this requires similar answers in terms of transparency. That was the reason for ESMA's public statement in July stressing the need for enhanced transparency regarding sovereign debt exposures. Also, last week's press release by the European Systemic Risk Board, which has identifying risks to stability as its core mission, only reinforced this point when asking for transparent and consistent valuation of sovereign exposures.

The main objective of financial reporting is to provide transparency on financial performance and positions to investors and the wider public. Transparency is extremely important for the good functioning of financial markets and for investor protection by keeping confidence of investors in financial reporting. IFRSs have clearly contributed to both the quality and quantity of the information provided as part of the financial statements presented by listed companies.

However, financial reporting does not only contribute to stability by providing reliable information on the position and performance of issuers. With all the emphasis on transparency we tend to forget that financial reporting is also used to determine the profits of an issuer, and these profits in turn affect, for example, the dividends that can be paid to shareholders and the bonuses to employees. Obviously, these cash-outflows can affect the stability of individual issuers. To sum up, correct application of financial reporting requirements is not only important for ensuring investor confidence, but is also important to maintain the health of an issuer.

The correct application of IFRS is of course first of all the responsibility of listed companies and their auditors. When IFRS is not applied correctly national authorities can use their enforcement powers. ESMA has in its turn the responsibility to ensure consistent enforcement across the EU.

As you will understand, we are currently looking at how banks are applying IFRS for the valuation of sovereign debt. It is very important for ESMA that financial institutions apply IFRS correctly, and are consistent in their valuations of sovereign debt exposures. This especially holds for the upcoming annual financial statements.

On the national enforcement of IFRS I would like to make one remark regarding your specific national situation. I understand that there is not yet independent supervision of financial reporting in Austria. In the spirit of this speech, I would like to emphasize that independent supervision of transparency in financial reporting is in my opinion an essential element of securities markets supervision.

To conclude

To conclude, in response to the question raised in the title of my presentation – Transparency: does it prevent crisis? – I think transparency cannot, in itself, be considered as a unique and sufficient tool that would guarantee good functioning of financial markets, but it is indeed an essential ingredient in the rich mix of different measures to be adopted to foster efficiency and integrity of financial markets and, ultimately, financial stability.

Thank you for your attention.