European Securities and Markets Authority

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Keynote address of Steven Maijoor, Chair of ESMA, Europlace Financial forum – Paris 4 July 2012

Ladies and Gentlemen,

Today I will talk about market structures and especially those relating to derivatives. However, let me first very briefly reflect on the topic of my contribution last year to this conference: the protection of the retail investor which is much debated at present in the revision of MIFID. There are many different aspects to the protection of the retail investor, and I would like to comment on one key element. This concerns the way advisors are compensated and whether they can receive commissions from advising certain products. I think it is important, not only for the retail investor but also for the reputation of the financial industry, that in addition to more disclosure, we move to banning commissions in certain circumstances. Commissions can give very biased incentives resulting in a too high risk of poor advice being provided. Hence, to conclude on this, I very much hope that the MIFID revision will result in the banning of commissions in the case of discretionary portfolio management and when advisors use the label "independent".

I will now move on to ESMA's recent work on derivatives and market infrastructures. Let me describe first, again, the bigger picture before I go into detail (and I must say there is an extreme level of technical detail in this area). Making derivatives markets safer is one of the objectives of the G20

commitments. An important lesson of this financial crisis is that derivatives can have devastating effects for financial markets therefore we need to make OTC derivatives safer and more transparent. The Regulation on OTC derivatives, central counterparties and trade repositories (EMIR), on which the Council and European Parliament agreed earlier this year, describes the main characteristics of the regulation and supervision of derivatives. ESMA has the task to draft a related extensive set of technical standards.

On 25 June, ESMA released a consultation paper on these technical standards. The consultation paper is almost 300 pages long and includes the actual draft technical standards and a qualitative impact assessment. The paper would have been even longer if we had not held the earlier consultation. All the explanations on the standards were already included in the discussion paper we issued in February and the current consultation paper only reports on the feed-back from the first consultation and our related responses.

Before delving into the main requirements included in the standards, let me summarise the process that brought us to this point:

- On 9 February the European Parliament, the Council and the Commission reached a political agreement;
- 5 working days later we issued a discussion paper for a 5½ week consultation period and on 6 March we organised an open hearing;
- On 19 March the 1st consultation closed and we received 135 responses (including the confidential ones);
- As just mentioned, in June we released the consultation paper for a six

week consultation period and on 12 July we will organise a second open hearing; and

- 30 September we plan to submit the technical standards to the European Commission.

So over a period of about 33 weeks we will have had 11 weeks of consultation, in two steps and with two open hearings. While I think that just over 33 weeks to complete technical standards is incredibly short, you can see that we do our utmost to get input from a broad range of stakeholders. As you are probably aware, ESMA has always argued for a period of about 12 months for completing technical standards. As an aside, the good news is that in the more recent legislative proposals relevant to ESMA we receive more time to draft technical standards.

Now turning to the substance, the consultation paper includes essential provisions for the implementation of the requirements set out in EMIR. Starting from the **clearing obligation**, in order for such an obligation to work in practice, we need to specify a number of elements, such as:

a) the information that should be notified to ESMA on the classes of OTC derivatives that might become subject to a clearing obligation;

b) the criteria that ESMA should assess to determine the classes of derivatives to which the clearing obligation should apply;

c) the information that will be included in the public register of the derivatives subject to the clearing obligation; and

d) the structure of indirect clearing arrangements, in order to allow counterparties that have no direct access to a CCP to clear their transactions.

Other important obligations established by EMIR for reducing the risks arising from OTC derivatives relate to *risk mitigation techniques* for OTC derivatives that are not centrally cleared. In this case the draft technical standards specify the exact requirements for such issues as timely confirmation, and portfolio reconciliation and compression.

EMIR also establishes certain exemptions from the clearing obligation and risk mitigation techniques for bilateral trades. These relate to non-financial counterparties and intragroup exemptions. The actual boundaries of these exemptions are left to our technical standards, which specify in the case of *non-financial counterparties*:

a) The definition of the OTC derivatives that reduce risks, the so called "hedging exemption"; and
b) The clearing thresholds below which the clearing obligation would not apply.

I should say that we are proposing a broad definition of hedging to ensure that end-users who use OTC derivatives to hedge risks related to their commercial business are exempted. In addition, this definition is very similar to the definition of our US counterparts. For the clearing thresholds I should say that we are fairly consistent with our international

counterparts, although this is, for example, complicated by substantial differences on this issue between EMIR and Dodd-Frank.

Another essential component of EMIR is ensuring that CCPs are safe and sound whatever financial instrument they clear. In order to do that, we cannot simply rely on high level regulation. We need to enter into the details of the risk management, organisation and business conduct of CCPs.

Our standards recognise that CCPs are generally the best placed to manage the risks arising from their clearing activity and this is the reason why a criteria based approach is adopted in most of the cases. However, to ensure that CCPs do not compete on risk grounds and that the systemic risk dimension of CCPs is duly taken into account, in certain cases we need to be prescriptive. To ensure safe and sound CCPs, our technical standards specify detailed organizational and prudential requirements. These include:

1) The governance arrangements in terms of structure, reporting lines, and dedicated human resources;
2) The coverage that CCP margins models should respect:

<u>For OTC derivatives:</u>

- 99.5% confidence interval;
- 5 days liquidation period

<u>For other financial instruments:</u>

- 99% confidence interval;
- 2 days liquidation period.

For all financial instruments the margin model should cover a look-back period that takes into account the most stressed market conditions. In addition, in all circumstances CCPs must raises these minimum requirements if certain conditions are met.

3) The size of the so called "skin in the game" i.e. the CCP's own resources that should be used after exhausting the resources of the defaulting clearing member. We set it at 50% of the minimum capital requirements; and
4) The type of collateral that CCPs can accept and the financial instruments in which they can invest.

Finally, the last big chapter is on trade repositories. In particular, the consultation paper proposes technical standards on the details and format of the information to be reported to trade repositories. This will ensure that trade repositories will serve their main objectives of increasing transparency in derivatives markets for the purpose of monitoring systemic risk and facilitate the detection of possible market abuses. We also propose standards regarding the information to be provided by trade repositories to ESMA for the purpose of their authorisation. Finally, standards are proposed regarding the data that trade repositories will need to make available to the public and the relevant authorities.

Final observations

Indeed all these reforms aim at ensuring that derivatives markets continue to serve their purposes of allowing for a proper hedging of risks. As stated earlier, we agreed these reforms at global level and we are implementing

them in every jurisdiction. On the international dimension of EMIR, I should mention that we are not yet consulting on the technical standards relating to the issue about which transactions outside the EU should be subject to the EMIR requirements. As you will understand, this is an area where we need to coordinate with our counterparts outside the EU before consulting on specific proposals.

Let me assure you that in these international discussions we take the approach that we should avoid breaking up a global market into a number of local ones for the simple purpose of applying our domestic rules. Europe has long experience of relying on each other's supervision and in assessing the equivalence of third country systems. These concepts have allowed European financial markets to grow significantly and if we want the global markets to grow as well, we would need to extend these principles at international level.

Thank you for your attention.