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Challenges in the European Supervision of Asset Management

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Steven Maijoor, ESMA Chair

Ladies and Gentlemen,

I am very pleased to have the opportunity to speak at your conference today. BVI is to be congratulated for hosting this event and for assembling such a broad range of key stakeholders during this period of significant change in the fund management industry.

I would like to take advantage of my presence here today to talk about the role of ESMA and provide you with an overview of some of the key topics on which ESMA has focused since its creation in January 2011. I will then go on to cover work streams that are of particular interest to the asset management industry.

ESMA as an organisation

ESMA was created on 1 January 2011 as a response to the financial crisis. Along with the European Banking Authority in London and the European Insurance and Occupational Pensions Authority here in Frankfurt, ESMA is one of the three new supervisory authorities (ESAs) that form part of the European System of Financial Supervision (ESFS). The European Systemic Risk Board, also based in Frankfurt, is another element of the ESFS. The establishment of the ESAs in particular was designed to strengthen supervisory co-operation and convergence within Europe. We have a number of tools at our disposal to achieve those objectives, including drafting binding technical standards, issuing guidelines and recommendations and taking actions in the case of breaches of Union law.

You will appreciate that in addition to developing our role in policy and supervision, we have also devoted much of our time recently to developing ESMA's internal organisation so we can carry out our mandate while remaining sufficiently flexible to respond to any further responsibilities we may receive. We will have grown from 45 staff in September 2011 to an expected 100 staff by the end of 2012, and I would like to stress that we are pleased with the calibre of our recruits.

ESMA • CS 60747 – 103 rue de Grenelle • 75345 Paris Cedex 07 • France • Tel. +33 (0) 1 58 36 43 21 • www.esma.europa.eu

Single rule book

One of ESMA's principal objectives is the creation of a single rule book in the area of securities markets regulation and this has been the focus of much of our work in recent months. To give you an idea of the volume of material we are producing, since September 2011 we have developed 51 draft regulatory and implementing standards and six sets of guidelines in areas such as credit rating agencies, short selling, high frequency trading, and alternative investment funds. I specifically want to mention the 40 technical standards that were developed for the implementation of EMIR and that we submitted to the European Commission on 27 September. This should allow the EU to meet its commitment to have rules in place for derivatives markets by January 2013.

I fully understand that all this regulatory activity to achieve a single rule book not only keeps ESMA very busy but also results in substantial implementation costs for the financial sector, at least in the short term. However, there can be no single market without a single rule book. Hence, I am convinced that the standardization of regulatory and supervisory practices will have major benefits for the European asset management industry.

Investor protection

One area of focus for ESMA which will come as no surprise to you is investor protection. We have strengthened the European framework for investor protection through a series of concrete initiatives. In July 2012, for example, we published two sets of guidelines aimed at enhancing the protection of investors. One set concerns the suitability of advice under MiFID and the other set concerns investment firms' requirements regarding the compliance function. While we are on the subject of advice under MiFID, I would also like to mention that inducements provided to advisers are an important factor leading to unsuitable products being recommended to clients. I firmly believe that the problem cannot be solved by yet more transparency alone. I fully support the proposal to ban inducements in certain situations as included in the proposal by the Commission for MiFID. Disclosure of inducements is simply not sufficient. At a minimum we need to ban inducements in the case of discretionary portfolio management and when an advisor wants to use the *independent* label.

Getting the incentives right for providing good advice to clients is in the interest of all of us. Tackling poor incentives only via corrective measures like internal controls and external supervision can add costs and may not always achieve the desired outcome. I am convinced that banning inducements will contribute to achieving a viable business model with a high level of investor trust – although this will also require efforts to improve financial awareness among investors. As a final remark on this topic, I indeed see the issue that it will take some adjustments, both on the industry side and the investor side, to move to a new business

model without inducements. Hence, giving some time to all stakeholders to adjust before a ban is introduced would be reasonable.

I will come back to some other work streams that are relevant for investor protection later. However, I would also mention the fact that we have exercised our power to issue warnings. In December 2011, we issued a warning on the main risks involved in forex trading, and last month we issued a warning on using the internet for investment purposes, following an observed rise in complaints reported by national authorities. The use of warnings is a very useful tool at our disposal when we identify a particular activity or practice that could pose risks to our investor protection objective.

Financial stability and crisis management

One outcome of the financial crisis we have been experiencing over the past few years has been the increased focus on financial stability and crisis management by securities markets regulators. This is equally true of ESMA. Our work in this area is a mix of specific projects and regular risk reporting. For example, we have completed specific work on the risks associated with the current industry trend towards structured and complex retail products, and the shadow banking system in Europe.

I would also like to highlight key aspects of ESMA's coordination activities in the context of "adverse market developments". The Board of Supervisors of ESMA held several conference calls in early summer to discuss the significant worsening of financial market conditions in the EU. The objective of these calls was to exchange information on key financial market developments in the EU, planned responses to those developments by national competent authorities and to assess where, and what type of coordination, was needed.

CRA supervision

This audience may be more familiar with ESMA in its role as a rule maker and standard setter. However, it should not be forgotten that ESMA also exercises direct supervisory powers in relation to credit rating agencies, while we will have a similar competence with respect to trade repositories in the near future.

In executing our supervisory responsibilities on CRAs, ESMA's CRA Unit has undertaken two on-site inspections at the three largest registered entities. The first inspections were carried out in December 2011 and the findings were published last March, while a second on-site inspection was completed last month. The March report identified several shortcomings and areas for improvement which ESMA is now following-up through risk mitigation plans for each individual CRA. On the basis of the second round of inspections last month on bank rating methodologies we are now examining the evidence in preparation of our supervisory findings.

<u>ESMA's work on investment funds</u>

Let me now concentrate on ESMA's work in the sector that is of particular interest to this audience. This will allow me to expand on our recent guidelines on ETFs and other UCITS issues, as well as their interaction with the broader shadow banking debate. I will also speak about a number of ongoing work streams in the context of the Alternative Investment Fund Managers Directive (AIFMD).

ETF guidelines

Turning first to the ETF guidelines, ESMA has been working on this issue since the summer of 2010. At an early stage we saw a need to intervene in this area to address a number of limitations in the existing regulatory framework. The problems were varied, covering both investor protection and transparency concerns, as well as more general systemic risk issues.

The first point I would like to make about these guidelines is that they take a comprehensive approach to the issues identified. By this I mean that, rather than setting out provisions applying to ETFs only, we considered that it made more sense from a regulatory perspective to tackle certain activities in a holistic way. So, while some of the new provisions are very relevant to ETFs, targeting only ETFs would have led to the risk of regulatory arbitrage and an uneven playing field.

Let us take securities lending as an example. This activity is clearly an important part of the operations of ETFs that use physical replication. However, we felt it appropriate to introduce new rules with respect to securities lending by any UCITS. These rules include additional disclosure to investors on the extent of this practice and the impact this could have on the risk profile of the fund. In the interests of safeguarding the liquidity of the fund, and the investor's right to redeem on demand, there is also an obligation on the UCITS to ensure that it is able to recall any asset lent out at any time.

In the same context, I would like to clarify our position on the issue of fee-sharing arrangements for securities lending – a topic that has attracted significant attention following publication of the guidelines. The guidelines require that all the revenues arising from securities lending, **net** of direct and indirect operational costs, should be returned to the UCITS. This does **not** mean that securities lending agents cannot charge a fee for their services, nor does this provision seek to reduce the scope for UCITS to engage in securities lending, which can be a valuable source of additional revenue. Rather, we take the view that the benefits arising from the use of the fund's assets should accrue to the investors in the fund, not to the management company.

Since investors would be the ones to suffer should problems arise from the securities lending activity, it seems reasonable that the profits generated by this practice should go to those same investors. Nevertheless, the formulation used in the guidelines leaves scope for the payment of fees to securities lending agents. With a view to ensuring a proper implementation of the guidelines at national level, it will be important to verify that the concept of ***direct and indirect operational costs*** is being applied in a way that is consistent with the underlying intention of this provision.

Circumvention

This brings me to a wider point that I would like to make that is relevant to ESMA's work more generally – with a provision of this nature it will always be possible to find a way to circumvent the rule. However, I would urge the industry to bear in mind that it is in a firm's interests to serve its investors, and that this new rule on revenues from securities lending has been designed with that in mind. Efforts should therefore be focused on complying both with the letter and the spirit of the requirement rather than on identifying potential loopholes or grey areas that could be exploited. This would avoid the need for further regulatory interventions. Finally, looking for loopholes and grey areas is not at all compatible with a sector in which gaining the trust of investors should be a guiding principle.

There are a couple of further issues that I would like to touch on which have some connection with the ETF guidelines – complex products and shadow banking.

Complex products/MiFID

Regarding complex products first of all, I would like to clarify – in case there is any doubt on this matter – that ESMA is not against complexity per se. Indeed, there will be cases where a more complex structure will render a product more suitable for an investor, such as via the inclusion of capital protection. However, it is equally clear that there are circumstances in which retail investors struggle to understand the complexity of a particular investment product, whether it be the internal workings of the product or the risk and reward profile. ESMA has several initiatives in place in relation to complex products.

For example, within the framework of the existing MiFID conduct of business requirements, we are working on proposals to improve implementation standards of those existing MiFID rules (on information to clients, suitability and appropriateness – in particular). This is partly in response to the *retailisation* of complex products which increases the risk that retail investors do not understand the risks attached to their investments and/or the drivers of risks and returns.

It is an important investor protection area in which we can improve supervisory convergence (by reinforcing MiFID conduct rules) especially in an era of:

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(i) growing complexity in financial instruments; and
(ii) increasing use of the internet (both by providers to approach investors, and by investors to access products).

In this regard, it seems likely that we will need to remind both supervisors and firms about selling practices, and ESMA's expectations, to be observed when selling complex products, including, for example, the sale of structured products to retail investors, and platforms giving access to complex products. We are currently developing an investor communication explaining the risks of investing in complex products, for example, structured products, CFDs, structured bonds and notes. This will be a complement to the investor warning ESMA issued last month regarding the pitfalls facing investors when using the internet for investment purposes.

On the distribution of complex products, we are continuing to map the various national initiatives to get a better understanding of the rationale for those initiatives, and to identify existing problems and issues. The aim is to consider what we could do at European level to improve investor protection in relation to the distribution of complex structured products, by establishing common ground where possible for distribution frameworks of complex structured products across the Union.

Shadow banking

Moving on to shadow banking, this sector has come to be recognised as an important part of the financial system, and as a significant source of intermediated funding for the financial and non-financial sector alike. After all, it is estimated at 11 trillion Euros in the Euro-area, hence about one-third of the conventional banking sector. The problem in shadow banking, of course, is the shadow. As important as its intermediation function may have become, the sector has retained a tainted image, owing to its role in the crisis, its inherent complexity, and the many critical risks involved. These risks still need to be better understood, and there is no doubt that the sector will continue to have the full attention of regulators and supervisors. However, I would like to emphasise that, in the EU and the U.S. alike, regulators have taken important steps in the past years not only to cast light on this segment of the financial market, but also to make it a safer place.

Due to those efforts today most shadow banking activities are already addressed by existing regulations. In addition, multiple regulations are in the process of implementation. The focus of regulators shifts now to the optimisation of that regulatory framework. We need to ensure that shadow bank activities and traditional banks are not exposed to incentives for regulatory arbitrage between the two sectors. Rather, shadow and traditional banking, and also their regulation, should complement each other.

ESMA has already substantially contributed to better regulation of the shadow banking sector. This includes our guidelines on money market funds published in 2010 and the work that I mentioned earlier on securities lending and repo transactions conducted by UCITS investment funds.

AIFMD

I would now like to devote some time to explaining the latest developments on ESMA's work in the context of the Alternative Investment Fund Managers Directive (AIFMD). While the Level 2 measures are being finalised by the European Commission, we have continued to make progress on three main work streams.

First, I would like to mention our guidelines on remuneration of AIFMs. We published our consultation paper in June and the deadline for feedback was last month. We are now analysing that feedback, including the valuable input from BVI, with a view to adopting final guidelines by the end of the year.

Another significant work stream under the AIFMD is the negotiation of the co-operation agreements with non-EU authorities, which have to be in place by July 2013. It is worth reiterating here that ESMA is leading the negotiations on behalf of the EU competent authorities. This makes sense both in terms of efficiency and in helping achieve a consistent result across jurisdictions. A common text has been agreed on the EU side and we are now negotiating with our non-EU counterparts on the basis of that text. We recognise the importance of having the agreements in place in a timely manner and will look to make progress as quickly as possible, of course bearing in mind the need to have robust arrangements that deliver what is required by the AIFMD.

Finally, I should mention our follow-up work on the discussion paper on key concepts of the AIFMD and types of AIFM that we published at the beginning of the year. We are aware that the outcome of this work, and in particular the technical standards required by Article 4(4) of the Directive aimed at determining types of AIFM, will be an important element of the future AIFMD framework and we are close to finalising a consultation paper for publication in the coming months.

Let me now conclude

I have spoken today about some of the key initiatives that ESMA is focusing on in its work, with specific emphasis on investment management. I have tried to highlight the interactions between them and the diversity of issues with which we – and therefore you – are faced on a daily basis. A central theme in all these issues is our common interest in gaining the trust of investors. I look forward to overcoming this challenge with the benefit of constructive engagement from the asset management industry.

Thank you for your attention.