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ESMA's role in markets reform

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Verena Ross

Executive Director

European Securities and Markets Authority

Thank you, Dan, for your kind introduction. Today, I will present an overview on the progress ESMA has made in meeting the large number of tasks on its list, our priorities for 2013 and to offer some insight into the specific work we have done in the area of trading and market structure.

Overview of ESMA

The impetus for ESMA's creation came from the European Union's determination to move towards more harmonised regulation and integrated European supervision in order to tackle the causes and effects of the crisis, and to ensure a true level playing field for all actors in the EU. It was also aimed at addressing failings in the areas of cooperation, coordination, consistent application of EU law and a lack of trust between supervisors.

This political decision led to the establishment of the European System of Financial Supervision and the creation of the three new European Supervisory Authorities for securities, banking and insurance on 1 January 2011. The system's objective is not only to secure a more robust legal framework for financial markets and its users, but also to provide benefits to investors and the wider economy.

ESMA was given the mission of improving the protection of investors and promoting stable and well-functioning financial markets in the EU and while ESMA also provides technical advice to the European Commission, it has a substantially expanded remit including supervisory powers over credit rating agencies and in the future trade repositories.

Finally, we are responsible for the coherent enforcement of EU law, delivering opinions on how to apply legislation, resolving disputes between supervisors in cross-border situations and coordinating responses in emergency situations.

ESMA's Role and its priorities

I would now like to move on to speak about our role, work programme and priorities. ESMA has two key objectives as an organisation. The first being the creation of a single rulebook for the regulation of the EU's financial markets and the second is achieving supervisory convergence and the consistent application and enforcement of that single rulebook. Both of these key objectives are to ensure that investors are receiving the same level of protection across the EU, while it also benefits the financial industry as it creates a level playing field and reduces the costs of providing services at a European level.

Now, let me focus on three key areas of work that have driven our activity over the last 2 years in pursuit of our mission, and will continue to do so in 2013.

<u>Single rule book</u>

One of ESMA's key activities is contributing to building a single rulebook for the regulation of the EU's financial markets and ensuring its consistent application at national level.

ESMA has played its part in producing detailed requirements and standards by:

- producing the technical standards for EMIR, credit rating agencies (CRAs) and short-selling;
- providing advice to the Commission for secondary legislation in areas such as prospectuses and alternative investment funds; and
- providing more detailed guidance and recommendations in areas such as automated trading and ETFs.

In 2013 this task of building a single rulebook for Europe will see the continuing revision of MiFID, which will be replaced by a revised directive and a new regulation, MiFID II and MiFIR, and the revision of the Market Abuse Directive. These texts both form part of the EU's key reforms in response to the financial crisis. Other planned legislation includes CRA III; the revision of the Transparency Directive; Regulations on Venture Capital (VC) and Social Entrepreneurship Funds (SEFs) and the Central Securities Depositories Directive (CSD). In support of implementing this legislation, and creating a single rulebook, ESMA will develop draft technical standards, guidelines and advice.

Supervisory convergence

The single rulebook is a necessary tool in dealing with the results of the crisis and building a safer and more efficient financial market, but this alone is not sufficient and it must be complemented by supervisory convergence in order to be fully and efficiently implemented on the ground. Part of ESMA's *raison d'être* is to foster supervisory convergence thereby reducing the risk of regulatory arbitrage which has the potential to undermine not only the integrity, efficiency and orderly functioning of markets but ultimately financial stability.

Direct supervision

Currently, ESMA is the only European Supervisory Authority exercising direct supervisory responsibilities over market participants with responsibility for the registration and supervision of CRAs and from 2013, ESMA will take on direct responsibility for the registration and supervision for Trade Repositories (TRs) under EMIR. Finally, ESMA will participate in the colleges that govern the registration and supervision of CCPs in order to ensure effective functioning and consistency of these colleges.

On derivatives reforms

The reform of the OTC derivatives markets agreed by the G20 has been implemented in Europe through EMIR and MiFID, with the clearing obligation dealt with under EMIR and the trading obligation in MiFID.

Now, let me first turn to EMIR, the regulation on OTC derivatives, central counterparties and reporting to trade repositories, which constitutes an important part of ESMA's recent and future work in the post-trading area. The new regime envisaged under EMIR will help by enhancing the protection of investors, promoting stable and well-functioning financial markets both in the EU and globally and ultimately benefit the real economy.

Before focusing on the implementation of EMIR's provisions, I would like to briefly revisit the process that allowed ESMA to deliver its final draft technical standards within the ambitious deadline of the end of September, and also the content of the main provisions in the standards.

The Process – Ambition v Time

On 9 February the European Parliament, the Council and the Commission reached a political agreement and ESMA issued its first discussion paper on 16 February for a 5½ week consultation period. The consultation, including an open hearing in March, closed on 19 March with 135 responses, and these formed the basis for the draft technical standards included in our 25 June consultation paper The second consultation period included another open hearing, attended by more than 200 stakeholders, and resulted in 165 responses being received the closing date on 5 August. This full, if rather compressed, process finally resulted in the delivery of the draft regulatory technical standards to the European Commission on 27 September. Looking back on the process now still tends to leave me breathless, but also very proud at what my staff managed to achieve in terms of the volume but also the quality of work during this short period.

The European Commission now has until the 27 of December to decide whether to endorse the draft regulatory technical standards. They will then move to the European Parliament and the Council for their endorsement which, depending on whether the standards have been amended or not by the Commission, may take from one month to three.

However, regardless of this procedural issue I would like to stress that with regard to the timing for implementation, certain provisions of the standards will not have a practical impact on market participants immediately. For example before a class of OTC derivatives becomes subject to mandatory clearing, there needs to be at least one CCP authorised or recognised under EMIR to clear this class. Moreover, time is needed to draft, consult on and issue the standards that will specify those mandatory classes. According to our projections, the first clearing obligation should start to apply during the summer of 2014.

In the same vein, trade repositories need to be operational and authorised under EMIR before the reporting obligation becomes effective. The standards include a phase-in approach to give the industry sufficient time to develop their reporting systems.

What is in EMIR

Now turning to the substance, the standards include essential provisions for the implementation of the requirements established in EMIR.

Starting with the clearing obligation, we specified a number of requirements including:

- the information that should be notified to ESMA on the classes of OTC derivatives;
- the criteria that ESMA should assess to determine those classes;
- the information that will be included in the public register; and
- the structure of indirect clearing arrangements, in order to allow counterparties that have no direct access to a CCP to clear their transactions.

The last point is of particular importance for many of you. This section of the standards was amended following feedback received during the consultation process, in particular to ensure that the standards were not giving indirect clients more rights than direct clients. However, its main purpose was retained which was to ensure that clients who do not have a direct access to a clearing member must benefit from an equivalent level of protection as direct clients. In particular, they must be given the option of choosing between segregated and omnibus accounts.

Other important obligations established under EMIR relate to risk mitigation techniques for OTC derivatives that are not centrally cleared. In this situation the technical standards specify the exact requirements for:

- Timely confirmation;
- Portfolio reconciliation and compression; and
- Dispute resolution;

Another essential goal of EMIR is to ensure that CCPs are safe and resilient whatever financial instrument they clear, but in order to do that, we cannot simply rely on principles based regulation. We need to enter into the details of the risk management, organisation and business conduct of CCPs.

However, to ensure that CCPs do not compete on risk grounds and that the systemic risk dimension of CCPs is taken into account, we needed to be prescriptive in certain cases.

Finally, the EMIR's technical standards focus on trade repositories. In particular, they set out the authorisation process for trade repositories, the details and format of the information to be reported to trade repositories and the data that they must make available to the public and the relevant authorities. These ensure that trade repositories serve their main objectives of increasing transparency in derivatives market, enabling regulators to monitor systemic risk and facilitate the detection of possible market abuse.

Further EMIR to come

We have not entirely finished our consultations with you, as certain standards that ESMA is required to draft under EMIR will be delivered in a second batch. These were delayed to ensure an appropriate level of consistency at the international level and relate to the provisions on extraterritoriality, i.e. how to prevent regulatory arbitrage, and the exchange of collateral for bilateral trades.

Let me expand on the latter, as this is a central point for you. Today counterparties do already exchange collateral but buy-side clients more often post than receive collateral.

However, we consider that clients should also be covered in the case of a default of their bigger counterparties. This is the reason why ESMA, in keeping with the wording in EMIR, is among the supporters of a two-way system in which the obligation to exchange collateral lies on both sides of the trade.

Although this option has an impact in terms of collateral availability, we strongly believe it will enhance the level of protection of the overall financial system, in particular for the buy-side industry. We would therefore encourage you to be more vocal in supporting this "universal two-way margining".

The delivery of the standards was only the first step of our EMIR work and we are now working on implementation issues, the key work streams being communication and the development of common processes. To this end, we are developing a set of communication tools to raise awareness and understanding of EMIR including the launch of a dedicated EMIR webpage, improved communication with industry associations and preparatory work for possible guidelines or Q&As. In addition we are agreeing on common processes and templates, to harmonise future communication between regulated entities, their regulators and ESMA.

It is clear that EMIR and other similar regulations around the globe do not come without a cost for market participants, but the benefits of having safer infrastructures (such as CCPs), more transparent markets (with TRs) and less counterparty credit risks (with central clearing and bilateral collateralisation) surely more than offset those costs.

MiFID and secondary markets

Now turning to the other pillar of our work on secondary markets, MiFID, and the preparation for MiFID II and MiFIR. Looking at the agenda for the rest of today's conference, there are a number of critical points to be discussed on secondary trading where ESMA has done a lot of work, and is in the midst of preparations for MiFID II/MiFIR.

In one of the current hot-topic areas, high-frequency trading, ESMA has published Guidelines on systems and controls in an automated trading environment. These are based on ESMA's view that technological innovation has a positive impact on market efficiency, but that trading systems and firms need to effectively contribute to fair and orderly trading. This challenge involves regulators too. The impact of algorithmic trading on the buy-side is of specific concern to ESMA and I would encourage buy-side participants to interact with us more on these issues, a previous fact-finding exercise targeted at buy-side participants in 2011 drew a very limited response. At present we are closely following the MiFID II negotiations where additional elements may be added to a future regulatory framework such as fee structures, co-location or tick sizes.

As you know, the Commission's proposal for the review of MiFID extended the MiFID transparency framework to bonds, structured finance products, emission allowances and derivatives. It is clear that the extension of transparency regimes beyond equities must be assessed by asset class and type of instrument within each asset class to prevent transparency harming liquidity. In that context, a mechanical extension of the MiFID transparency requirements for equity to non-equity financial instruments would not be the correct approach. ESMA is committed to engaging with stakeholders to ensure that our work in this area does not suffer from a lack of data.

CESR had previously assessed positively the general MiFID pre-trade transparency framework for equities, including the necessity of limited pre-trade transparency in specific cases. In that context, ESMA has made a significant effort to revise all the current operational waivers in the EU and this experience will be useful in analysing where necessary the limitations of pre-trade transparency for other instruments.

To conclude on MiFID, one of its key principles is transferring trading in derivatives, which are eligible for clearing and with sufficient liquidity, into regulated markets, MTFs or other OTFs. However, it seems clear that there are limits to what can actually be traded on these types of platforms, there are also differences in the way in which derivatives can be traded compared to equities trading, but despite the differences, it is evident that certain features of the equities market structure can and will be brought to derivatives trading.

Investment Management

Let me now say a few words about ESMA's work in the area of investment management, which is of course of crucial importance to this audience. We have been very active in the past year in both the UCITS and alternative investment sectors and the regulatory agenda for next year looks like it will be equally busy.

ESMA's guidelines on ETFs and other UCITS issues are now close to finalisation. These guidelines are the culmination of over two years of work and aim at strengthening investor protection and preventing systemic risk. As we highlighted in our response to the European Commission's Green Paper, the guidelines are also very relevant to the debate on shadow banking.

It is important to note at the outset the comprehensive nature of these guidelines. Although we have tackled some issues arising specifically from ETFs, we have been careful to put in place rules that recognise the horizontal nature of the activities concerned. For example, the new framework strengthens the rules on securities lending by UCITS in general rather than limiting the rules to ETFs. This all-encompassing approach avoids the risk that the activity in question simply migrates to a different type of fund.

Let me take one example of how the guidelines cover both investor protection and systemic risk issues – the provisions on collateral management. As far as investor protection is concerned, UCITS will be required to include information in their prospectuses regarding their collateral policy and the additional risks to which this could give rise. This should help increase transparency and allow more informed investment decisions. From the perspective of systemic risk, meanwhile, the requirement that the UCITS must not sell, reinvest or pledge non-cash collateral will help to reduce the scope for lengthy chains of collateral spreading across numerous counterparties. On a related point, the guidelines clearly circumscribe what a UCITS may do with cash collateral it receives, such as placing it on deposit or investing it in short-term money market funds. This is designed to recognise the role that collateral plays as a risk mitigation mechanism.

In terms of process, ESMA has now agreed a final approach on the one outstanding point that was not covered in the guidelines published in July, namely the treatment of repo and reverse repo transactions. The full package of guidelines, incorporating the part on repo, will be formally issued before the end of the year and will apply two months from that date.

Moving to the Alternative Investment Fund Managers Directive (AIFMD), our efforts this year have focused on supplementing the future requirements at Level 1 and Level 2. There are three key workstreams on which I will say a few words.

First, we have been developing guidelines on sound remuneration policies. We set out our proposals in a consultation paper in June and are now in the process of finalising our approach based on the feedback received. We are planning to finalise the guidelines at the beginning of next year.

The second area where we have been active in the AIFMD space is in developing the regulatory technical standards on types of AIFM, as required by Article 4(4) of the Directive, and clarifying key concepts in the Directive. We published a discussion paper (DP) in February and will soon issue a follow-up consultation. In this context, it has been necessary to follow closely the developments in the discussions on the Level 2 measures since some of that material is likely to address issues that we had identified in our February DP. Similarly, we have been monitoring the work of the European Commission on the transposition of the Directive in order to take due account of those developments.

Finally, you will all be aware that the AIFMD includes a rather complex framework of rules with respect to non-EU entities. In order for non-EU AIFMs to be allowed to manage or market AIFs in the EU from July 2013 onwards, one of the requirements imposed by the Directive is the existence of supervisory co-operation arrangements between the relevant EU and non-EU authorities. The same requirement applies in a number of other cases, such as when an EU AIFM wishes to delegate portfolio or risk management to an entity outside the EU or when an EU AIFM wishes to market non-EU AIFs in the EU. Taking into account the number of jurisdictions with which cooperation arrangements need to be agreed, the tight timetable and the need to have a consistent approach across jurisdictions, it was agreed that ESMA would negotiate the MoUs on behalf of the national authorities. I am pleased to report that we are making good progress on agreeing these MoUs, and you may have seen the press release we published yesterday announcing the first of these agreements, which has been reached with the Swiss regulator. We will continue to treat this as a high priority in the coming months with a view to getting satisfactory MoUs in place by July of next year (and well in advance of that date wherever possible). This is a positive step in view of the G20 commitments on stronger international supervisory co-operation and we are very pleased to play our part in achieving that objective.

The International Dimension

The reforms I have spoken of today are driven by the G20 commitments and so I would like to touch, ever so briefly, on the topic of international cooperation amongst securities regulators.

ESMA's view is that regulating international and interconnected financial markets from a national perspective is a mismatch, and as no single regulator can seek to regulate global financial markets from one location, we need to rely on equivalence, mutual recognition and cooperation in order to make progress. There is no alternative to close international cooperation, both in the setting of standards and in the execution of day-to-day supervision, if we want to achieve an efficient system for global financial markets.

Yesterday's publication of the details of our cooperation arrangements with the Swiss regulator is just one of a number of work streams currently underway, including cooperation on OTC derivatives reforms. ESMA is committed to a strong international community of securities markets regulators working together to achieve realistic solutions, and will continue to promote and facilitate this work.

Conclusion

Let me conclude this morning by once again thanking ICI Global for allowing me the opportunity to share my thoughts on how ESMA's work in the area of derivatives and trading is contributing to creating a common rulebook and supervisory approach for the EU and how this supports and promotes stable and well-functioning EU financial markets and enhancing investor protection.

The crisis has led to an unprecedented number of legislative initiatives in the EU. However, these changes do not happen in isolation and so I would like to leave you with the final thought that, while these changes require market participants to adapt to new requirements, you also have a key contribution to make in the dialogue between regulators and markets, and to how our markets look and function in the future.

Thank you for your attention.