European Securities and Markets Authority

ESMA's supervision of credit rating agencies, trade repositories and monitoring of third country central counterparties

2016 annual report and 2017 work programme

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List of Acronyms

CEO	Chief Executive Officer
CCP	Central Counter Party
CEREP	CEntral REPository of credit rating data reported by CRAs to ESMA according to Commission Delegated Regulation 448/2012 of 21 March 2012 with regard to regulatory technical standards for the presentation of the information that credit rating agencies shall make available in a central repository established by the European Securities and Markets Authority
CFTC	U.S. Commodity Futures Trading Commission
CME TR	CME Trade Repository Ltd.
CPMI	Committee on Payments and Market Infrastructures
CRA	Credit Rating Agency
CRA Regulation	Regulation (EC) No 1060/2009 on credit rating agencies as amended by Regulation 513/2011 of 11 May 2011 and Regulation 462/2013 of 21 May 2013
CRR	Capital Requirements Regulation, Regulation (EU) no 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) no 648/2012
DB	Deutsche Boerse AG
Delegated Regulation on Fees	Delegated Regulation 2015/1 of 30 September 2014 on the reporting of fees charged by credit rating agencies
DDRL	DTCC Derivatives Repository Ltd.
DQAP	Data Quality Action Plan
ECB	European Central Bank
EMIR	Regulation 648/2012 on OTC derivatives, central counterparties and trade repositories
ERP	European Rating Platform
ESMA	European Securities and Markets Authority

ESMA Regulation	Regulation 1095/2010 of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority)
ESRB	European Systemic Risk Board
ETD	Exchange Traded Derivative
EU	European Union
Fitch	Credit rating agencies within the Fitch group of companies
FX CFD	Foreign Exchange Contract for Difference
G7	Canada, France, Germany, Italy, Japan, the United Kingdom and the United States
ICE TVEL	ICE Trade Vault Europe Ltd.
IIO	Independent Investigating Officer
INED	Independent Non-Executive Director
IOSCO	International Organization of Securities Commissions
IT	Information Technology
ITS	Implementing Technical Standards
KDPW	Krajowy Depozyt Papierów Wartosciowych S.A.
LSE	London Stock Exchange Group plc
MIS	Moody's Investors Service
MoU	Memorandum of Understanding
Moody's	Credit rating agencies within Moody's Corporation
NCA	National Competent Authority
OTC	Over-the-counter
Q&A	Questions and answers
RADAR	ESMA's credit RAtings DAta Reporting tool
Regis-TR	Regis-TR S.A.

REMIT	Regulation 1227/2011 of 25 October 2011 on wholesale energy market integrity and transparency
RTS	Regulatory Technical Standard
SFTR	Securities Financing Transactions Regulation
S&P	Credit rating agencies within S&P Global Inc.
TC-CCP	Third-Country (non-European) Central Counter Party
TR	Trade Repository
TRACE	ESMA's Trade Repository Data Reporting tool
UK	United Kingdom
UnaVista	UnaVista Limited

Executive Summary

Reasons for publication

This annual report and work programme highlight the direct supervisory activities carried out by ESMA during 2016 regarding credit rating agencies (CRAs) and trade repositories (TRs) and outline ESMA's main priorities in these areas for 2017. In addition, this document outlines ESMA's activities regarding the monitoring of non-European central counterparties (TC-CCPs) in 2016 and going forward into 2017.

Main activities of 2016 and priorities for 2017

1. Over the course of 2016, ESMA further strengthened its supervisory approach regarding CRAs, TRs and TC-CCPs. ESMA's supervisory activities and achievements for 2016 are:

   TR and CRA supervision

   - Supervision of six registered TRs, 26 registered CRAs and four certified CRAs;
   - Supervisory work to improve the quality of data reported by TRs and launched a framework to increase cooperation between NCAs and ESMA;
   - Investigations on a number of issues occurring within TRs including access to TR data and the operation and performance of their systems;
   - Publication of the Guidelines on the validation and review of CRAs' methodologies;
   - Investigations on conflicts of interest, the robustness of the rating process, review of methodologies and governance arrangements of CRAs;
   - Monitoring of the governance, independence, internal control structure, IT infrastructure and information security of CRAs;
   - Go-live of the European Ratings Platform to provide access to free, up-to-date information on credit ratings and rating outlooks;
   - Imposition of ESMA's first fine on a TR, DTCC Derivatives Repository Limited for failure to ensure direct and immediate access for regulators to data reported; and
   - Imposition of a EUR 1 380 000 fine with respect to Fitch Ratings Limited for failure to comply with a number of requirements of the CRA Regulation.

   TC-CCPs

   - Recognition of 11 TC-CCPs from a variety of jurisdictions following the November 2015 and March 2016 equivalence decisions from the Commission;
   - Monitoring of the activities and services provided by recognised TC-CCPs in the EU; and

- Data gathering on interlinkages and exposures of EU entities with those TC-CCPs.

2. For 2017, ESMA has conducted a supervisory risk assessment for CRA and TR supervision, which identified the following priorities:

   TR supervision

   - Data quality and access by authorities;
   - Technology trends and internal control; and
   - Strategy and governance.

   CRA supervision

   - Quality of credit ratings;
   - IT and internal controls;
   - Strategy and governance; and
   - Risk assessment and data.

3. In addition, there are a number of areas where there are common issues across TRs and CRAs on which ESMA will perform further work including fees charged for both core and ancillary services and information security.

4. For TC-CCPs, ESMA has identified the following priorities for 2017:

   - Assessment of the 21 pending applications for recognition as TC-CCPs;
   - Review the classes of OTC derivatives cleared by recognised TC-CCPs; and
   - Finalisation of the risk based analysis framework in relation to TC-CCPs activity in the EU.

ESMA adopts a risk-based approach to the supervision of CRAs and TRs in accordance with its overall objectives of promoting financial stability and orderly markets and enhancing investor protection. This risk-based approach requires the analysis of information from a variety of sources and the application of multiple supervisory tools including thematic reviews, regular meetings with different functions of the supervised entities, on-site inspections and dedicated investigations. This annual report and work programme outlines how this approach was applied in 2016, and how this approach is expected to be applied in 2017.

TR supervision

The supervision of TRs by ESMA started in 2013 with their registration. ESMA had registered six TRs by November 2013, which triggered the trade reporting obligations to TRs set out in EMIR. ESMA's supervisory work requires close cooperation with National Competent Authorities (NCAs) in the EU Member States as they are responsible for supervising the counterparties reporting to TRs. NCAs are amongst the key users of TR data.

Trade reporting to TRs began in February 2014. By the end of 2016, almost 44 billion reports had been received by TRs, with an average of around 400 million trade reports submitted per week. ESMA has observed increasing interest in the TR business and is currently assessing new applications for registration. In addition, ESMA notes that registered TRs are looking to expand their businesses into new areas, for example by offering other reporting services.

The risk assessment exercise carried out in 2015 identified that the highest risks facing the TR industry related to their data quality, data access, information security and business continuity and financial risks. Based on the identification of these risks, ESMA's activities in 2016 specifically focused on data access and data quality, the monitoring of TR governance and strategy, adequacy of resources and the complexity of IT system-design and operations.

ESMA's supervision activities have led to some significant improvements in overall data quality. More specifically, as regards data quality and data access, ESMA carried out some specific supervisory activities regarding TR systems' operation and performance, which in some cases required significant changes to some TRs' systems. ESMA has also started to consider TRs' resilience to potential cyber-attacks and effective business continuity during the course of 2016. The broad spectrum of ESMA's supervisory focus and ESMA's ability to monitor market developments and respond promptly to incidents is starting to show improvements in each of these areas.

ESMA monitored the governance and strategy of TRs via various approaches in 2016. For example, ESMA entered into active discussions with senior management and Board members in order to understand the strategic direction TRs are exploring. ESMA also actively promoted a more embedded compliance culture and conveyed its expectations for the compliance function to senior management and the Boards of TRs.

The level of resources dedicated to the TR business remained an area of concern for ESMA during 2016. Turnover of key staff noticeably increased throughout 2016. In addition, ESMA has identified a risk that some TRs might not be in a position to influence the relevant decision making processes or to assess the appropriateness and effectiveness of the services provided by parent companies or affiliates. ESMA also dedicated significant attention to the efforts that TRs are putting towards the achievement of a smooth and reliable operation of their systems by using a variety of supervisory tools.

In 2016, ESMA adopted its first enforcement decision against a TR. In March 2016, the ESMA Board of Supervisors issued a public notice in respect of the infringements found to have been committed by DDRL and imposed a fine of €64,000 for negligently failing to put in place systems capable of providing regulators with direct and immediate access to derivatives trading data.

The risk-based assessment performed for 2016 was updated to identify the highest risks related to the operation of TRs and their compliance with EMIR. The key risks identified are a further refinement of the 2016 risks. The main priorities for TR supervision in 2017 will include data quality, data access, technology changes, internal controls, strategy and governance.

CRA supervision

ESMA is currently supervising 26 registered and 4 certified CRAs. Over the course of 2016, ESMA received one application for registration as a CRA, which was refused. At the same time, ESMA still frequently receives expressions of intentions to apply for registration.

As part of its supervisory activities regarding CRAs, ESMA continuously carried out perimeter assessments in 2016 to identify entities that may be issuing credit ratings without registering with ESMA. Throughout 2016, ESMA has requested information from several companies, including a number of financial intermediaries, to assess whether their investment research or investment recommendation activities fall within the scope of the CRA Regulation.

For 2016, ESMA identified CRAs governance and strategy and quality of ratings as its priorities. In 2016, ESMA observed significant changes in the governance and strategy of various CRAs. More aggressive business strategies of supervised entities required ESMA's attention to ensure growth plans are coupled with sufficient resources for the CRAs' analytical, compliance and internal review functions.

Within the governance of CRAs, ESMA also focused on conflicts of interest and the independence of the rating process. ESMA concluded a number of investigations in this area and followed-up on other issues in its day-to-day supervision. As part of its priorities for 2016, ESMA also monitored the effectiveness of CRAs' internal control structures.

Regarding the quality of ratings, an important achievement for ESMA was the publication of the Guidelines on the validation and review of CRAs' methodologies, which sets standards for the use of quantitative and qualitative techniques throughout the CRA industry. ESMA also conducted investigations into the rating process of several CRAs and continuously examined the quality and accuracy of credit ratings issued by CRAs and reported to ESMA. Furthermore, following the conclusion of its IT risk assessment ESMA continued its work regarding CRAs' IT infrastructure, IT internal controls and information security.

In 2016, ESMA also focused its resources on further enhancing its risk-based approach to supervision. ESMA invested in developing the RAtings DAta Reporting tool (RADAR) and the European Rating Platform (ERP). Through RADAR, CRAs are providing ESMA with information on credit ratings and pricing practices and fees charged for these credit ratings and ancillary services. ESMA launched the ERP to provide access to free, up-to-date information on credit ratings and rating outlooks. In providing granular information on specific rated entities and instruments to the public, the ERP complements the statistical data on CRAs' rating activities and rating performance, which ESMA already publishes via its CEntral REPository database (CEREP).

ESMA actively participated in the global supervisory colleges during 2016, which consist of ESMA and the main CRA supervisors outside the EU for the three largest and internationally operating CRAs (Fitch, Moody's and S&P). ESMA also interacted on a bilateral basis with supervisors outside the EU during 2016 to inform its supervisory activities on specific topics including conflicts of interest, internal controls, the adequacy of the validation of methodologies and the role of the compliance function.

In 2016, ESMA took enforcement action against Fitch Ratings Limited. The ESMA Board of Supervisors found that Fitch had committed infringements relating to three separate points of the CRA Regulation and imposed various fines totalling EUR 1.38 million.

In 2017, ESMA will focus its attention on rating quality, IT infrastructure including the use of cloud computing and internal controls. Furthermore, ESMA will monitor CRAs' business strategies and the quality of senior management, including the management of (potential) conflicts of interest. Finally, and in order to support its supervisory risk assessment, enhancing the quality of the information reported by CRAs will be a further theme of ESMA's supervisory work in 2017.

Areas of common supervisory focus for CRAs and TRs

During 2016, joint work was performed by ESMA in the area of fees charged by CRAs and TRs. For 2017, ESMA identified a number of supervisory areas, which are common to both CRAs and TRs, such as their approaches to internal control frameworks, IT, including cloud computing, and the supervision of fees and ancillary services in 2017.

ESMA will make use of all the supervisory tools at its disposal to achieve its objectives and will, in particular, seek to make increased use of investigations and to publish one or more thematic reports to outline its views and clarify its expectations on issues of interest in appropriate cases.

TC-CCP recognition

Regarding TC-CCPs acting in the EU, ESMA must recognise TC-CCPs initially and when they extend their range of activities and services. ESMA also assesses whether the classes of OTC derivatives cleared by recognised TC-CCPs should be subject to the clearing obligation as foreseen in EMIR.

In 2016, ESMA performed the recognition process for 11 TC-CCPs following the publication of new corresponding equivalence decisions by the Commission in November 2015 and March 2016 including the check of conditions for US CCPs supervised by the US CFTC.

In 2017, ESMA will pursue the recognition process of the remaining TC-CCPs applicants for which an equivalence decision is adopted and of recognised TC-CCPs extending their activity together with the assessment of the related clearing obligation for the relevant OTC derivatives. ESMA will negotiate and sign the corresponding MoUs. It will monitor that recognised TC-CCPs comply with the EMIR criteria and equivalence conditions, if applicable, on an ongoing basis.

TC-CCP monitoring

In the context of its overarching objectives of promoting financial stability and orderly markets and enhancing investor protection ESMA monitors recognised TC-CCPs activities in relation to the EU.

To this end in 2016 ESMA launched a data collection exercise, through the cooperation channels it set-up with EU and non-EU national competent authorities on risks for EU entities and markets.

In 2017, ESMA will finalise the definition of the corresponding indicators to detect any unmitigated risks for the EU coming from recognised TC-CCPs and, if needed, find the remediation in cooperation with the relevant EU and non-EU authorities.

Introduction

1. The European Securities and Markets Authority (ESMA) is one of the three European Supervisory Authorities, which, together with the European Systemic Risk Board (ESRB) and National Competent Authorities, make up the European System of Financial Supervision (ESFS).

2. The ESFS was established in the wake of the global financial crisis with the aim of improving the quality and consistency of supervision, strengthening the oversight of cross-border groups and establishing a single rule book for all financial market participants within the European Union (EU).

3. ESMA's mission is to enhance investor protection and promote stable and orderly financial markets. In 2011, ESMA was designated as the single supervisor of credit rating agencies (CRAs) within the EU in accordance with the provisions of Regulation 1060/2009 on credit rating agencies.[1] The following year, ESMA was given direct responsibility for the registration and the supervision of trade repositories (TRs) within the EU and the monitoring of non-European central counterparties (TC-CCPs) activity in relation to the EU in accordance with Regulation 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR).[2]

4. In accordance with ESMA's strategic orientation for 2016-2020,[3] ESMA is continuing to strengthen its role as a direct supervisor. The Supervision Department follows a risk-based approach for TR and CRA supervision and focuses its action in those areas where its resources may have the greatest impact.

5. Furthermore, through TC-CCP monitoring ESMA is reinforcing its capacity to identify and assess the related risks to EU investors and more globally to financial stability in the EU. 2016 saw a significant increase in the number of recognised TC-CCP in jurisdictions that are particularly relevant for the EU. ESMA is thus finalising its data collection through the cooperation channels it set-up with EU and non-EU national competent authorities to best allocate its means to concentrate on risk for EU entities and markets.

6. This report provides an overview of the activities undertaken by ESMA in 2016 pursuant to the CRA Regulation and EMIR and sets out ESMA's supervision work programme for 2017.

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[1] Regulation No 1060/2009 of 16 September 2009 on credit rating agencies, OJ L 302/1 of 17.11.2009 available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2009.302.01.0001.01.ENG&toc=OJ:L:2009:302:TOC, as amended by Regulation 513/2001 of 11 May 2011. OJ L145/30 of 31.5.2011 available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:145:0030:0056:EN:PDF (hereinafter the CRA Regulation).

[2] Regulation No 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, OJ L 201/1 of 27.7.2012 available at http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32012R0648 (hereinafter EMIR).

[3] ESMA/2015/935, ESMA Strategic Orientation 2016-2020, 15 June 2015, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-935_esma_strategic_orientation_2016-2020.pdf.

A. Supervision of Trade Repositories and Credit Rating Agencies

1 Effectiveness

7. In accordance with its strategic orientation for 2016-2020, ESMA is continuing to strengthen its role as a direct supervisor of CRAs and TRs. As part of this process, ESMA assesses the effectiveness of its supervisory activities with a view to evaluate the impact of its actions and to better identify the areas of supervisory focus for the following years.

8. The supervision of CRAs by ESMA started in 2011. In 2016, ESMA supervised 40 registered CRAs, including four groups of CRAs with multiple registered entities, and four certified CRAs. The supervision of TRs by ESMA started in 2013 with the registration of TRs in accordance with EMIR. In 2016, ESMA supervised six registered TRs.

9. To carry out an effective supervision in line with ESMA's objectives of promoting financial stability and orderly markets and enhancing investor protection, ESMA has taken the following steps:

   - Adoption of a risk-based approach to supervision with tailored approaches for CRAs and TRs, to capture the specificities of the two industries and their players.
   - Focus on the risks that are more likely to materialise and negatively impact financial stability or orderly markets or cause harm to investors.
   - Use of a variety of supervisory tools, tailored to specific risks and entities.

1.1 Risk assessment and supervisory tools

10. In order for ESMA to be able to adopt a risk-based approach to supervision, it was necessary to construct robust risk assessment frameworks. For both CRAs and TRs, ESMA set up the frameworks in the early stages of these new supervisory regimes. These frameworks cover a range of risks, including for example data quality and IT system reliability for TRs and governance and operational risks for CRAs. Although the frameworks were developed separately, some of the risks covered by the risk assessments are similar across both industries (e.g. operational risks).

11. ESMA both assesses entity-level and industry-level risks. The industry-level or top-down approach enables ESMA to assess the developments of supervised entities within the prevailing market dynamics, whether entity-specific or across several entities.

12. ESMA uses information gathered from a wide range of sources to conduct its supervisory risk assessments for CRAs and TRs. In addition to performing its own market intelligence, ESMA gathers information from the supervised entities through the periodic information submitted to it, incident reporting, formal and informal requests for information, risk-mapping exercises, regular and ad hoc meetings with staff at all levels, and exit and entry

interviews with key staff. Another important source of information are the stakeholders, including issuers and investors, whether through informal interactions or formal complaints. In addition, ESMA receives information through its cooperation with national and sectoral competent authorities and third country supervisors.

13. Based on the information received, ESMA performs its risk assessment, which takes into account both industry-level and entity-level issues. Over the years, ESMA has further refined its risk assessment and will continue to do so in the coming years. The risk assessment is then used to define annual entity-specific or risk-specific strategies, which take into account available resources. It also enables ESMA to re-prioritise its actions where necessary due to ad hoc events or market developments.

14. In defining its supervisory actions to address the risks identified, ESMA does not use a one-size-fits-all approach but tailors its actions to the type of risk or challenge at stake, taking into account its urgency, size and complexity and the history of the supervised entity. In addition, ESMA differentiates its approach depending on the objective it wants to achieve. In some instances, ESMA adopts a thematic approach, which creates an opportunity to look at certain issues across entities and allows for peer comparisons. In other cases, where issues seem to be concentrated in one entity, ESMA takes more focused action. Depending on the nature of the issue, ESMA can opt to promote good practices while in other cases an investigation may be necessary to understand whether an issue constitutes a harmful practice that needs to be put to an end.

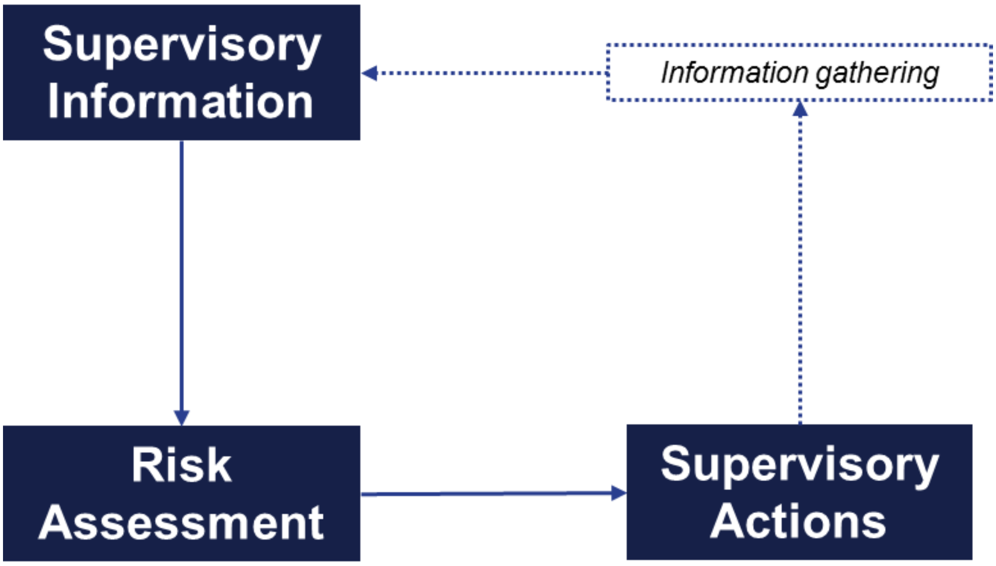
15. By applying the above-mentioned criteria, ESMA has identified different supervisory tools to mitigate or resolve the risks it has observed:

    - Interactions with the Board of Directors, INEDs, senior management and key staff, bilaterally and through ad hoc events, roundtables and ‘town hall’ meetings to deliver key messages and expectations and promote good practices.
    - Development of Guidelines and Q&As to promote a consistent application of regulatory requirements.
    - Targeted letters to senior management setting out key messages or requesting information to better inform ESMA’s risk assessment and understanding.
    - Engagements with supervised entities in risk mapping exercises over certain types of risks, which can help to make entities better aware of the risks they face and how to address these.
    - Investigations, which can be individual or thematic and target large or small and medium-sized entities.
    - On-site inspections which maybe either announced or unannounced.
    - Agreement on a remedial action plan with the relevant entity following an investigation to remediate the shortcomings observed in a comprehensive way.
    - Increase transparency and monitoring of the development of projects, their progress and resources.

- Specific actions to verify data quality, such as data validations and inter-TR reconciliation review.

16. The information gathered through the use of the tools listed above also feeds back into the risk assessment thereby creating a continuous cycle of information and regulatory interaction (see Figure 1).

Figure 1 - Cycle of information and regulatory interaction



1.2 Key risks identified by ESMA's supervision

17. One of the main challenges for ESMA during the setup of its supervision of CRAs was the fact that the CRA industry was an established industry which had only been regulated for a short amount of time. Therefore, in its first years ESMA focused on assessing and addressing structural issues identified in the systems and processes set up by CRAs to comply with the new regulatory framework. In particular, ESMA focused on the integrity, independence and ability of these systems and processes to deliver objective and high quality ratings.

18. In this context, the assessments carried out by ESMA over the years have identified several areas of high risk regarding CRAs:

- Risks linked to CRAs' internal controls, namely: internal control mechanisms, the empowerment and effectiveness of the compliance and methodology review functions, the adequacy and effectiveness of internal controls, including the role of INEDs in this respect, as well as the adequacy and effectiveness of the IT internal controls.

- Risks linked to strategy and business development, in particular: the ability of CRAs to compete and to expand their business without a negative impact on the quality of their credit ratings and the independence of the credit rating process from commercial and business interests.

- Risks linked to the integrity of the rating process, including the processes established to ensure thorough and well-guided rating decisions based on methodologies that are rigorous, systematic, continuous and subject to validation.

19. Contrary to CRAs, TRs were a newly established industry when ESMA took up its supervisory duties. To this end, an important challenge consisted in ensuring TRs were ready to perform their activities in an adequate manner upon registration. Furthermore, ESMA has worked to promote higher quality work by TRs, most notably in terms of quality, consistency and completeness of the data reported by TRs.

20. In this context, the high risks observed in TRs concentrated around the following areas:

    - Risks linked to the start of TRs' activity, in particular: the adequacy and efficiency of the on-boarding process of regulators; and the TR systems' readiness and ability to receive reports from counterparties and cope with the reporting volumes.
    - Operational risks, including the reliability and performance of TR systems' operations, the confidentiality of TR data and the ongoing availability and accessibility of data, including information security and business continuity.
    - Risks linked to data quality, including the completeness, consistency and accuracy of data released by TRs.
    - Financial risks in relation to TRs, including the financial sustainability, adequate funding and pricing decisions and ability to provide their services on a continuous basis.

1.3 Key achievements of ESMA's supervision

21. ESMA has been reporting on the results and achievements of its supervision in annual and ad hoc reports. While supervision is ongoing work and ESMA cannot make conclusive judgments on the reduction of certain risks, the main changes observed in the CRA and TR industries as a consequence of ESMA' supervisory activity can be grouped as follows.

Switch to a regulated industry with focus on integrity of processes

22. Successfully converting the CRA industry into a regulated one has been one of the key objectives of ESMA since 2011. ESMA has driven significant changes in the credit rating process and the methodology and business development process thereby strengthening their integrity, independence, quality and transparency.

Establishment of TRs

23. Ensuring that TRs have the ability to carry out their activities in an effective and continuous manner was one of ESMA's key areas of focus when starting its supervision of TRs. ESMA has monitored the readiness of TR systems to process the required information and provide regulators with the required level of data access.

Internal control system

24. ESMA's supervisory work has triggered improvements in the empowerment and effectiveness of CRA's internal control functions, most notably the compliance, methodology review and internal audit functions. In addition, ESMA's work has contributed and enabled CRAs to rethink and in certain cases redesign their internal control system, including their organisational structure. ESMA has also observed gradual improvements in the design and effectiveness of TR internal control frameworks.

Importance of IT controls

25. ESMA's supervisory work has further increased the awareness of TRs and CRAs' senior management and Board regarding the importance of IT internal controls and their adverse impact on respectively TRs' data quality and CRAs' business performance and quality of ratings; it has further highlighted the importance of a sound IT governance.

Corporate culture

26. ESMA has promoted the establishment of a culture of integrity, compliance and ethics within CRAs and TRs. In addition, ESMA has stressed the need for an open dialogue between itself and supervised entities. In this context, ESMA has observed changes in the approach towards compliance, in some instances moving away from formal to substantive compliance and a better integration of compliance in the organisation.

Senior management

27. ESMA has encouraged a strengthening of the governance structures of CRAs and TRs, urging senior management to promote a culture of compliance and setting the correct tone from the top. INEDs have in several cases stepped up in discharging their monitoring and oversight responsibilities and in challenging decisions and processes within supervised entities with a view to improve integrity and responsibility.

Improving data quality

28. Over the past years, ESMA has observed improvements in the quality of data reported by TRs through the validation exercises conducted and the inter-TR reconciliation. ESMA is convinced that further improvement is necessary in this area and will continue to make significant efforts to achieve this objective.

1.4 Strengthening direct supervision

29. Over the past years, ESMA has continuously worked on improving the effectiveness and efficiency of its direct supervision. Beyond the activities and achievements reported in this Annual Report, ESMA highlights the following key improvements.

Risk assessment

30. ESMA has started enhancing its risk assessment framework with a view to harmonisation across the CRA and TR industry. Although the framework will differentiate between the two industries, the underlying methodology and tools will be identical. This will allow

further integration of information gathering and risk identification that builds on best practices across both industries.

Synergies and supervisory expertise

31. ESMA has exploited the synergies in its CRA and TR supervisory work. ESMA has harmonised and fine-tuned its practices, building on the expertise and good practices acquired in the two industries. ESMA has also conducted cross-industry supervisory work with regard to common risk areas such as the work on fees and ancillary services and the outcome of the UK referendum. Going forward, significant synergies are expected to be achieved in the field of information security, cyber security, corporate governance and cloud computing.

Focus of supervisory work

32. ESMA has deepened its supervisory focus by carrying out more targeted investigations and ad hoc supervisory actions to address specific concerns. This has allowed ESMA to request CRAs and TRs to remediate the shortcomings observed in a more targeted and swifter manner.

Supervisory reach

33. ESMA has increased its supervisory reach in absolute terms by carrying out more investigations and on-site inspections compared to the previous years, and by increasing its interactions and meetings with key staff of CRAs and TRs.

Supervisory tools

34. ESMA has improved the IT tools that support its supervisory work. The go-live of RADAR is improving the consistency of information reported, adding value to ESMA's supervision and providing reliable data on credit ratings through the ERP. In addition, ESMA has developed forensic capacities with software that supports the analysis of data and information, in particular in the context of its investigations, speeding up and broadening ESMA's ability to collect data and identify findings. Finally, ESMA has improved its internal systems for processing information received from CRAs and TRs, automating the production of information and statistics on CRAs and improving its TR data validation.

1.5 The way forward

35. Establishing effective direct supervision requires continuous development, challenge and a forward-looking approach. The first years of ESMA's supervision have focused on the groundwork, so that CRAs and TRs could develop the right foundations on which to base their operations in accordance with their respective regulatory frameworks. In the coming years, ESMA will concentrate its efforts in the areas listed below in order to become an even more efficient and effective regulator of CRAs and TRs.

The quality of credit ratings and TR data

36. ESMA will focus more attention on the quality of credit ratings and TR data by further developing its information-gathering tools like the RADAR system and greater use of new forensic tools to deepen its investigations. In addition, ESMA will further strengthen its cooperation with NCAs to achieve a more comprehensive and structured approach to TR data quality.

Cooperation with stakeholders

37. Users of credit ratings, counterparties, NCAs, sectoral competent authorities and third country regulators share with ESMA the common interest of having well-functioning CRAs and TRs. ESMA intends to intensify its collaboration and dialogue with all relevant stakeholders with the view to better understand the risks and challenges of these industries and target its action accordingly.

New risk framework

38. In 2017, ESMA will continue the development of a new risk assessment framework for CRAs and TRs. This will provide for a more targeted supervisory approach by allowing for a more granular and continuous risk identification, which will better inform ESMA's supervisory actions.

Periodic information requirements

39. ESMA will further improve the format and content of the information received from CRAs and TRs on a periodic basis to support a more efficient information flow from entities to ESMA and realise a better integration between the information received and the way this information feeds into the risk assessment framework.

Supervisory tools

40. In the coming years ESMA will continue to work on the development of more supervisory tools where necessary to ensure it can conduct impactful and efficient supervision.

41. The work programme for 2017 describes further some of the initiatives that ESMA will undertake in the above-mentioned areas in the short term.

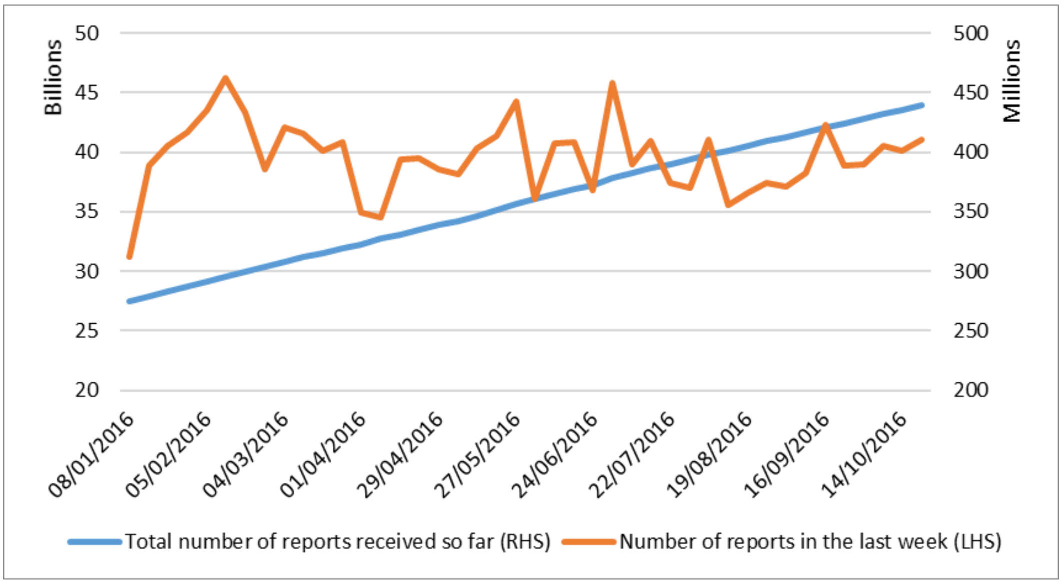
2 Trade Repositories

2.1 Industry state of play

42. During 2016, the TR industry has remained relatively stable with six TRs registered and supervised by ESMA. The role of TRs with respect to receiving, processing and providing access to derivatives trade reports, is crucial to support a more transparent and accessible EU derivatives market. Currently, 44 regulatory authorities including NCAs and central banks have access to at least one EU TR and are able to view and analyse the data in line with their mandates.

43. By the end of 2016 the six TRs operating in the EU had collected nearly 44 billion reports in total. The reports do not only include new trades but also their modifications and other lifecycle events. During the course of this year, the level of reporting activity has stabilised at an average of around 400 million submissions per week, as illustrated in Figure 2 below.

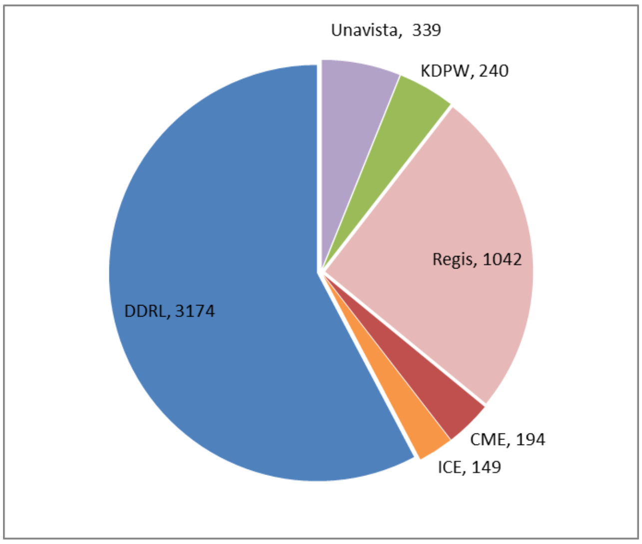
Figure 2 - Total number of reports received since reporting began in 2014



Source: ESMA calculations based on weekly reports from all TRs

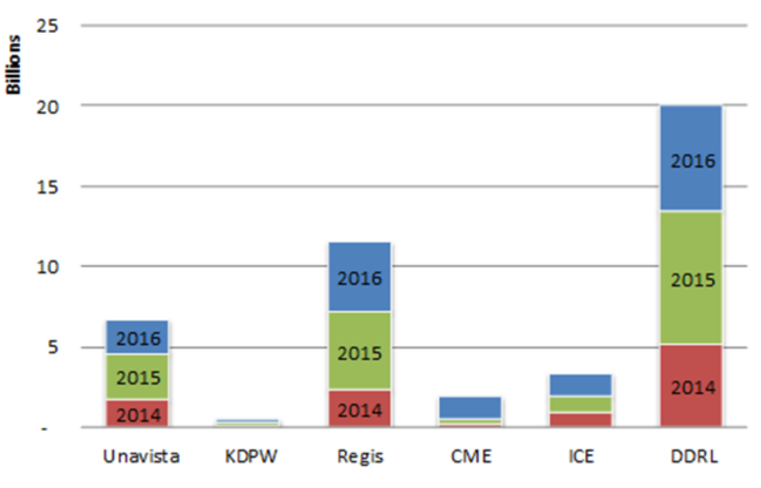
44. Overall, the six EU registered TRs have maintained a similar market share to last year. Compared to its peers, DDRL continues to lead in terms of number of clients served and reports received. Other TRs further strengthened their client base through other services offered by the groups of companies they belong to. Proximity of the TR (e.g. same country and same group as the reporting entity) also seems to be considered by clients in their choice of TR.

Figure 3 - Number of clients per TR, as of October 2016



Source: ESMA calculations based on weekly reports from all TRs

Figure 4 - Number of reports received so far as of October 2016



Source: ESMA calculations based on weekly reports from all TRs

45. In 2016, ESMA started to assess the applications of two new entities who have applied for registration in the EU. Furthermore, some recent changes in the political, competitive, regulatory and technological landscape are likely to further change and shape the TR industry.

46. In particular, the expected guidance on portability, clarifying how clients can migrate from one TR to another, is expected to trigger more movement of TR clients. In that respect, it is interesting to note that TRs seem to be expanding their commercial offerings. For example, in 2015 three TRs started offering reporting services related to wholesale energy market integrity and transparency (REMIT) under Regulation 1227/2011 of 25 October 2011.[4] Furthermore, the entry into force of the Securities Financing Transactions Regulation (SFTR) provides opportunities for existing TRs and new players.

47. Another opportunity for TRs is the provision of multi-jurisdictional reporting services, as new jurisdictions are starting to introduce legal frameworks in order to ensure the resilience and transparency of the derivatives markets. For example, in Switzerland, the Financial Markets Infrastructure Act, adopted in 2015 and coming into force as of 1st of January 2016, is similar to EMIR. The transaction reporting obligation will start 6 months after the registration or recognition of the first TR in Switzerland and may trigger EU registered TRs to expand their offerings to the Swiss market.

48. Other regulatory changes such as the review of the regulatory and implementing technical standards on reporting under Article 9 of EMIR[5] will also impact TRs and their relevant stakeholders as reporting and processing technologies will have to be adjusted to the new standards. The revised standards will simplify and provide more clarity on the

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[4] ICE TVEL, Regis-TR and CME TR

[5] http://ec.europa.eu/finance/financial-markets/docs/derivatives/161026-implementing-regulation_en.pdf and http://ec.europa.eu/finance/financial-markets/docs/derivatives/161019-delegated-regulation_en.pdf

way counterparties report the details of their derivatives and TRs will need to be ready to accurately validate the data reported under these revised standards.

49. In its Consultation Paper on public data[6] ESMA has set out detailed requirements relating to the aggregate data that TRs publish on a weekly basis which will require further adjustments from TRs. The main change is that the aggregate data currently made available by TRs will need to give more detail on commodity derivatives and derivatives using benchmarks.

50. Another important milestone for 2017 is the completion of the second phase of the TRACE project (see paragraph 70). The first phase of this central portal, facilitating the access of competent authorities to TR data, was launched in August 2016 and introduced standardised data reports and a single data access point. The next part of the project should allow regulators to make tailored data requests and will require considerable technological effort by TRs.

51. Against these changes, it is important to stress that while the effect of political, market and regulatory factors on TRs is difficult to predict, TRs need to ensure compliance with EMIR under all circumstances. ESMA's role is to monitor whether TRs meet their obligations under EMIR and to take supervisory actions where necessary. The main observations, actions and achievements from ESMA's TR supervision in 2016 are reported further below.

2.2 Supervision

52. In line with the priorities set out in the TR supervision work programme for 2016[7], ESMA focused its attention on data access, data quality, information security and business continuity and financial risks of TRs.

53. More specifically, ESMA's activities focussed on monitoring TR governance and strategy (including competition, strategic decisions and compliance culture), adequacy of resources (in terms of human and financial resources and outsourced functions), IT system operations and on data access and data quality more generally. Where necessary, due to ad hoc events or information received, and in line with its risk-based approach, ESMA has also reprioritised issues to focus on the highest risk areas. Examples of ad hoc events that resulted in a reprioritisation are reported incidents that required immediate attention as they had a direct impact on availability and access to data.

[6] https://www.esma.europa.eu/sites/default/files/library/2016-1661_consultation_paper_on_tr_public_data_under_emir.pdf

[7] See pages 49 through 52 of the Supervision work plan for 2016 for TRs: https://www.esma.europa.eu/sites/default/files/library/2016-234_esma_2015_annual_report_on_supervision_and_2016_work_plan.pdf

2.2.1 Data quality and data access

54. High quality data provision is an essential part of the TRs' role in enhancing the transparency of derivative markets and reducing risks to financial stability. More specifically, poor quality data limits the possibilities for regulatory authorities to reduce systemic counterparty and operational risk and to help prevent financial system failures. In order to be able to do so, TRs must make the necessary information available to regulatory authorities in order for them to fulfil their respective responsibilities and mandates. Therefore, the efficiency of the TRs in light of the EMIR framework depends on proper access to data for public authorities and the quality of that data.

Data quality action plan

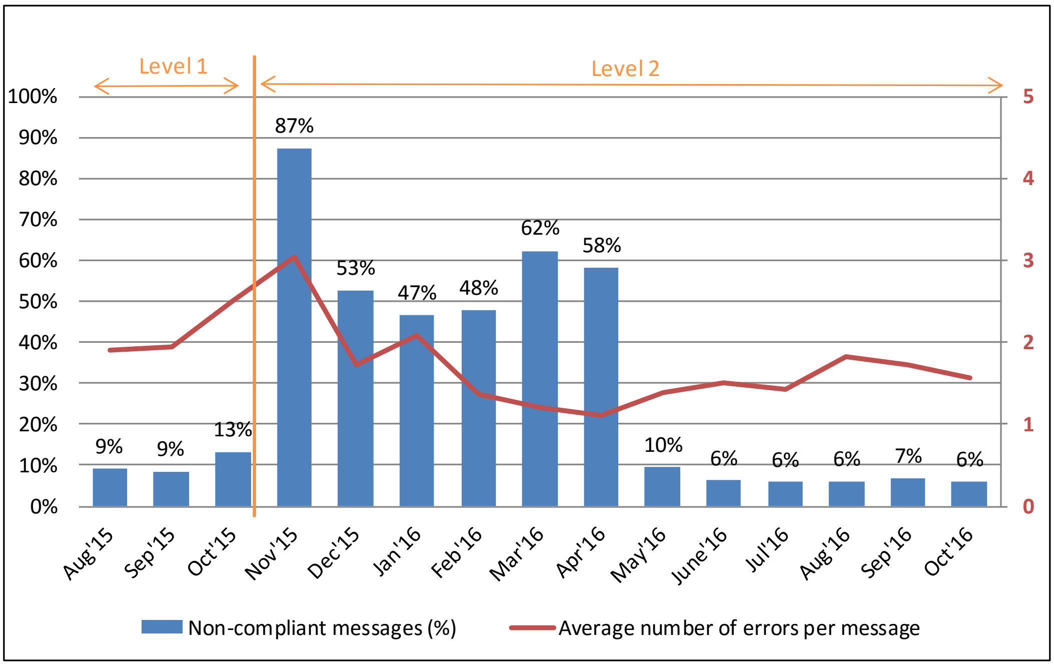
55. TR data quality is affected by both counterparties who file data and TRs themselves which process it. Given the dual supervisory framework of EMIR, where ESMA supervises TRs and NCAs supervise the entities who report to TRs, a joint effort is necessary to ensure high quality data. Against this background, in September 2014, ESMA and NCAs jointly launched the multi-annual 'Data Quality Action Plan' (DQAP) which aims to improve the quality and usability of data that is reported to and by the TRs.

Data Validation

56. The key component of the DQAP is data validation. In December 2014, Level 1 validation rules were implemented by TRs with the objective to validate whether mandatory fields were indeed available and whether blanks or fields that contained a "not available" value were allowed to have these values. Reports that do not comply with these validation rules are expected to be rejected by TRs. The second level of validation rules was implemented by TRs in November 2015 with the objective that fields are validated by TRs to ensure that accepted reports comply in terms of content and format with the rules set out in the technical standards.

57. Following the introduction of the validation rules, ESMA regularly performs a re-validation of the data made available by TRs. The objective is to assess whether the validation requirements have been implemented correctly by the TRs. ESMA randomly selects one day each month for which the complete daily activity reports across all TRs are re-validated. When necessary, ESMA has followed up with the TRs to make sure the necessary fixes are implemented. The joint efforts led to a reduction of rejection rates of non-compliant messages to 6%. The graph below presents the results of the re-validation performed from August 2015 to October 2016.

Figure 5 – Rejection rates after re-validation across all TRs



Source: ESMA calculations based on daily activity reports from all TRs

58. By informing the TRs which fields contained erroneous values and by stressing the importance of data quality, ESMA's supervision activities have led to improvements in overall data quality. The monitoring of data quality through re-validation is an ongoing activity, and is anticipated to intensify with the expected application in 2017 of the revised regulatory and implementing technical standards on reporting under Article 9 of EMIR (RTS/ITS).

59. As indicated in the above chart, the data made available to ESMA during the period immediately after the introduction of Level 2 validation was to a large extent non-compliant with the validation requirements. Based on this trend, there could be an expected increase in noncompliant messages when the revised RTS/ITS is expected to come into force during 2017.

60. The quality of data reported to TRs also defines the usability and accuracy of the aggregate data that is publicly made available by TRs on their websites on a weekly basis. Although the format of aggregate reports is standardised across TRs, the content still depends a lot on the contribution of all parties involved in the reporting process.

Inter-TR Reconciliation

61. Another component of the DQAP is further improving the results of inter-TR reconciliation. The EU reporting regime requires both counterparties to a trade to report the transaction. The TRs are obliged to reconcile the trades between themselves where counterparties report to different TRs. However, in practice this process has not been that straightforward mainly for data quality reasons.

62. Following the extensive review and subsequent roundtable at ESMA on the inter-TR reconciliation process in 2015, ESMA staff has focused on the implementation of the

follow up action points agreed among the TRs and ESMA. The various action points on both TR-specific- as well as collective-level, were designed to harmonise and streamline the inter-TR reconciliation process to avoid any failures due to varying implementation of the process among TRs. In 2016, ESMA staff have primarily focused on the implementation of these actions by the supervised TRs.

63. Most notably, ESMA has encouraged TRs to coordinate their efforts so as to find an agreement among themselves on the implementation approaches and definitions of key elements of the inter-TR reconciliation process. For that purpose, TRs have established a system of weekly meetings and inter-TR reconciliation statistics exchanges in order for the TRs to identify discrepancies in the process and to design adequate remediation.

64. Finally, ESMA has begun to closely engage with NCAs and exchange data, using the Reconciliation Status Report, to identify counterparties where reporting causes large amounts of breaks in the reconciliation process. Going forward, ESMA plans to further intensify its engagement with the NCAs as part of a more formalised NCA cooperation framework[8].

65. In 2016, ESMA continued to monitor the data received from TRs via the data quality dashboard developed in 2015. The dashboard is updated on a monthly basis and summarises statistics that indicate the level of data quality across different dimensions. The current dashboard supports the monitoring of re-validations, rejections, public data, reconciliation information and other data characteristics. This overview allows for the identification of data quality trends and persistent issues that would not otherwise have been discovered. The tool will be reviewed and improved in the future to enable ESMA to even better identify data quality issues.

66. In addition to the DQAP, ESMA has initiated in 2016 a new framework to further increase cooperation with NCAs regarding data quality issues, which is expected to be expanded to include additional authorities analysing TR data. The aim of this framework is to prevent the replication of effort for several NCAs that may pursue similar issues with TRs in parallel, while also providing clarity to the NCAs as to why certain issues are getting priority. This process involves collating data quality issue information from NCAs in a clearer format through a standardised template. These issues are then gathered and prioritised by ESMA. The list of prioritised issues is then communicated to NCAs to allow for increased transparency of all outstanding issues. ESMA receives comments from NCAs on an ongoing basis regarding counterparty reporting to TRs.

67. ESMA is also working with NCAs to improve counterparty reporting. Although NCAs supervise counterparties directly, ESMA is in a unique position of being able to analyse the whole market to identify counterparties' reporting inconsistencies across all jurisdictions, in addition to the quality of data from TRs. ESMA will continue to work closely with NCAs to assist in identifying issues that relate to counterparties' reporting practices.

[8] For additional background on the NCA cooperation framework, please refer to paragraph 202

68. As the data quality from the TRs improves, the formal NCA cooperation framework will help in centralising common issues with many reporting counterparties. Encouraging correct reporting practices of individual counterparties and in particular those with high reporting activity, will lead to more visible data quality improvements.

Data access

69. By the end of 2016, the TRs reported on behalf of approximately 5,500 direct clients. This number includes third parties who report on behalf of other counterparties and entities. These counterparties and entities have only the right to view data that has been reported on their behalf. In total, there are around 300,000 counterparties whose trades are reported to TRs. Some NCAs are not yet using their right to access and use TR data, possibly due to a lack of resources needed to process the data received from the different TRs.

70. ESMA has monitored the progress on access to TRs by competent authorities throughout 2016. As of November 2016, 44 regulatory authorities including NCAs and central banks had access to at least one TR. In order to further facilitate competent authorities' access to TR data, ESMA has developed an IT system (TRACE) which allows NCAs to have a single point of access to the data stored by TRs under the EMIR legislation. When fully implemented, this project should assist regulatory authorities in using TR data more actively.

71. Data access was also addressed in two TR investigations, which were conducted and closed in 2016. In both of these ESMA observed shortcomings in the internal organisation of access to TR systems. For instance, access might not have been granted according to the "need-to-know" principle. ESMA also observed a risk for the preservation of TR data confidentiality and set out specific remedial actions which include enhancing existing procedures for granting and reviewing access rights, improving controls included in the on-boarding process to enhance confidentiality, both for counterparties and regulators.

2.2.2 Governance and Strategy

72. In light of changing market dynamics and to better understand the entity-specific governance and the strategic directions that TRs are taking, ESMA actively engaged with TRs through on-site visits. The objective of these visits was to engage on both strategic and operational matters with key staff, senior management and the Board. In general, throughout 2016 ESMA intensified its dialogue with supervised entities in line with their risk profile.

Competition and strategic decisions

73. In terms of strategic direction, apart from further improving their core services offered under EMIR, TRs are likely to explore different possibilities to add value to these services or expand their businesses in new directions, such as SFTR or TR services in other jurisdictions. This seems to be driven by the fact that TR clients prefer to have easy access to a number of different services across the EU and other jurisdictions and TRs want to be able to offer an attractive set of services in order to remain competitive.

74. During 2016, as part of its work on fees and ancillary services, ESMA has started looking into the fee schedules of TRs more actively and noticed that TRs are adjusting their fees schedules more frequently in reaction to different market practices. For example, TRs are re-considering the initial pricing of delegated reporting, i.e. where third parties report to TRs on behalf of other market participants. Such service providers send significant volumes of reports to TRs on behalf of a multitude of different market participants. There are more than 300,000 counterparties in the EU whose trades are reported to TRs but only around 6,000 direct clients of TRs. ESMA expects TRs to ensure it charges cost-based fees.

75. ESMA expects that fee schedules may become an area of greater importance when the TR portability guidance is in place and when market participants have a better and more consistent understanding of how migration of reporting from one TR to another can take place.

Compliance culture

76. ESMA notices a marked difference in compliance culture across TRs. ESMA is concerned about the involvement, independence and empowerment of the compliance function in certain TRs. The differences across TRs were particularly noticeable in 2016 through a lack of pro-activeness in notifying ESMA of important changes. For example, there were instances where ESMA was not notified in a timely manner about changes being implemented in the TR systems. A lack of reactiveness or even inappropriate push-back to remediation requested by ESMA was also observed in for example the implementation of certain Q&As and data quality related requests. In general, ESMA did not observe sufficient challenge and involvement of the compliance function in the decision-making process e.g. on system changes and prioritisation of incidents for remediation.

77. TRs are market infrastructures based on technological solutions. Therefore, in order to understand how a TR functions, IT technical skills are required. ESMA has observed that compliance officers of TRs do not necessarily have such technical skills, which makes it difficult to assess strategic decisions that are taken by the TR regarding for example system design. However, ESMA would like to stress the importance of the compliance function's involvement in all material decisions as the compliance function is best suited to advise the company on compliance with relevant regulations. Therefore, ESMA encourages senior management of TRs to expand the skillset of their compliance functions to include more IT technical skills in order to ensure that the compliance function can perform its role and provide appropriate challenge.

78. Some TRs are further improving their system design in order to be able to process the reports more efficiently and to increase the quality of data. ESMA believes that such changes are key to a successful TR operation. Therefore, the compliance function is expected to be involved in the planning, testing and implementation of such projects.

79. In addition, TRs are exposed to operational incidents which may temporarily affect the performance of these market infrastructures. For example, in 2016, ESMA received more than 20 notifications of incidents of varying materiality. Some of these incidents were

purely operational in nature and did not have any impact on the TR's functioning or compliance with EMIR. However, other incidents resulted in inaccurate or incomplete data being provided to regulators. In such cases, the involvement of the compliance function regarding the implementation of necessary fixes and remedial actions, is crucial (for additional information on TR incidents, see section 2.2.5).

80. In light of the above, during day-to-day interactions with TRs, ESMA has been actively promoting a more embedded compliance culture and has conveyed its expectations for the compliance function to senior management and the Board. More specifically, ESMA has stressed the importance of establishing a compliance-oriented culture from the Board and Senior Management level down into the organisation. This includes maintaining an effective internal control system. In addition, ESMA will continue to assess whether the compliance function has the necessary authority, resources, expertise, and access to all relevant information to perform its role.

2.2.3 Resources

81. The level of resources dedicated to the TR business remains an area of concern. A number of TRs have progressed over the past years in order to optimise their resources in terms of staff, costs and technological solutions, others are still lagging behind. It is important to stress that at all times TRs need to have sufficient and appropriate resources to perform their functions so that they are able to fulfil their main obligation under EMIR.

Increased key staff turnover

82. Turnover of key staff noticeably increased throughout 2016. In fact, a majority of the material changes to the conditions of registrations notified to ESMA by TRs in 2016 related to the change of key staff.

83. Through meetings with the senior management of the TRs ESMA made it clear that TRs need to have sufficiently qualified and experienced resources, especially in periods of high staff turnover. Considering the importance of TRs in financial stability and taking into account the complexity of these financial market infrastructures it is very important that business continuity is ensured under all circumstances.

84. With TRs typically being part of global market players, sufficiency of resources is also a matter of priority for the TR within the group to which it belongs. In that respect, the discussions with TR board members, have been very insightful. The discussions allowed ESMA to better understand how the EU TR operations fit within their own group strategy and to stress that TRs need to have adequate staff and other resources in order to be EMIR compliant.

85. Sufficiency of resources was also part of one of the investigations that was conducted and closed in 2016. More specifically, during the investigation it was observed that due to an overreliance on only a few individuals, a clear separation between functions so as to safeguard the segregation of control and operational activities was not in place. Remedial actions agreed with the TR following the investigation include hiring additional staff to take up one of the functions involved.

Outsourcing

86. The fact that most TRs belong to larger groups of companies also has an impact on the TR outsourcing decisions and practices. ESMA has identified a risk that some TRs might not be in a position to influence the relevant decision making processes and assess the appropriateness and effectiveness of the services provided by parent companies or affiliates. This is of particular concern considering that the technology services of TRs are often outsourced to other companies that belong to the same group. Due to the lack of specific IT skills within the TR, it may be difficult to assess whether the decisions and timeframes driven by the group, relating to the technological enhancements or fixes of TR systems, are appropriate.

87. In 2016 ESMA reached out to the board members of TRs to emphasise that TR services should receive sufficient attention from the group in order to ensure compliance with EMIR.

88. One of the investigations that was conducted and closed in 2016 was focused on the outsourcing of IT functions. The findings related to insufficient senior management monitoring of the quality of outsourced IT services provided and, more generally, the inadequacy of resources dedicated to the TR activity within the group. Remedial actions agreed with the TR following the investigation contained specific steps related to the revision of the outsourcing agreements and of the outsourced services monitoring framework. For example, one TR will need to design and implement a revised set of metrics to monitor the performance of the outsourced services.

Financial resources

89. In 2016, ESMA continued to regularly monitor the financial situation of the registered TRs on the basis of the audited annual financial statements and interim financial statements submitted.

90. One of the conditions for registration of TRs is to have sufficient liquid net assets funded by equity to cover potential general business losses in order to continue providing services as a going concern. In addition, a TR should assess the sufficiency of its financial resources with the aim of covering the operational costs of a wind-down or reorganisation of the critical operations and services over at least a 6-month period.

91. Through its ongoing supervision, ESMA has followed up with the TRs to have a better understanding of their financial results. Furthermore, ESMA has engaged to better understand to what extent strategic decisions are expected to enhance financial performance.

92. The financial analysis that ESMA conducts is not limited to the legal entity accounts. Where applicable, the costs and revenues of the TR services as a product within the group have been considered, i.e. the management accounts were also taken into consideration. The assessment of such information will continue in 2017, amongst others to better understand the extent to which the transfer pricing agreements that TRs as legal entities enter into with other group companies, are in line with the EMIR provisions related

to pricing. These provisions stipulate that access to TRs needs to be non-discriminatory and TR fees should be cost-related and publicly disclosed.

Book of Work

93. In the context of increasing transparency and visibility on allocation and sufficiency of resources, current and planned TR development projects, priority setting, and timelines of actions, ESMA has introduced a process to exchange information with TRs about their respective Book of Work.

94. More specifically, the objectives of this initiative are to:

- have more visibility on the portfolio of planned and ongoing projects, prioritisation, size, and nature (e.g. project scope, total effort planned, internal project or ESMA initiated one, timelines);
- increase transparency on the adequacy of resources that are allocated to these projects;
- be informed on the progress and status of these projects against the agreed schedule and plan; and
- be informed on issues, risks or events that might lead to or justify proposed deviations from the agreed plans and deadlines.

95. In order to achieve these objectives, a standard template for exchanging information has been developed and shared with TRs. Information and respective updates are received on a bi-monthly basis. Collected information is analysed regularly and feeds into ESMA's supervisory actions and engagement with TRs. The process has been applied to five of the TRs while it is anticipated to be deployed to the remaining one in the next few months.

2.2.4 IT systems design and operation

96. TRs are technology-based market infrastructures and the robustness and reliability of their IT systems is an important driver of their ability to perform their duties under EMIR. Reporting entities, including counterparties, report derivative trades to TRs as prescribed by EMIR and the respective technical standards on reporting[9]. Subsequently, reported information is validated, processed and recorded. Trade details are filtered according to the specific mandates of the authorities that are entitled to access them and finally a set of reports is generated and delivered to regulators. This process has to be implemented in a way which respects and supports EMIR requirements such as data accuracy, data integrity, data confidentiality and operational separation. When considering the volumes of submissions TRs receive on a weekly basis (400 million per week) and the timeframes that must be respected (the data needs to be available to regulators in a timely manner),

[9] Commission delegated regulation (EU) No 148/2013 of 19 December 2012 and Commission implementing regulation (EU) No 1247/2012 of 19 December 2012

it is clear that automation of all or most parts of the process is necessary and the reliance on the various IT system components for complete and accurate processing is essential.

97. In 2016, as part of its on-going TR supervision ESMA dedicated significant attention to the TRs' efforts towards achieving smooth and reliable systems operation. This has been achieved through interactions with supervised entities at various levels within their organisations, in-depth investigations, active monitoring of TR incidents and material changes, data quality follow-up and the thematic review on cyber risk and security.

98. Furthermore, in 2016 ESMA closed one investigation into a TR where among other subject matters it focused on the issues related to operational reliability and data integrity. Some findings concerned the lack of procedures and controls for data quality and data integrity, on the validation of data received from the counterparties. Other findings related to the complex data submission structure, the substantive levels of transformation of the data received from counterparties and the lack of procedures and automatised controls for data quality and data integrity. The remedial actions that the TR started to implement include improvements of the technical documentation of its systems and introduction of further changes and controls with regard to enhancing and maintaining the integrity, completeness and accuracy of the TR data.

2.2.5 Material changes and Trade Repository incidents

99. Certain TRs have initiated in 2016 material changes which relate to their systems architecture. More specifically, currently two TRs are in the process of re-structuring their systems so as to increase their operational efficiency, better serve their client needs, and better satisfy current and forthcoming regulatory requirements. The entities are combining changes in system architecture with other developments triggered by regulatory changes such as the second phase of TRACE and amended reporting standards. While ESMA acknowledges that the planning and phasing of such big projects is crucial, ESMA remains concerned that combining several projects in single releases trigger additional risks and TRs need to undertake the necessary assessment and action to address such risks.

100. Throughout the year, several major incidents have been reported or identified by ESMA. These incidents affected availability and access to data by regulatory authorities and the public.

101. As an example, one TR identified that due to a system design flaw it did not include all the trades that it was supposed to in the reports provided to regulators. As a result, NCAs were not able to access this data for a period of time.

102. In June 2016, there was a lack of clarity on how the markets would behave in relation to the UK referendum. It was not clear whether volatility would increase, nor when or to what extent. Even in the most extreme scenario TRs need to ensure that their capacity to ingest, process and make data available is sufficient and that there are no delays in providing the data to regulatory authorities.

103. Although market volatility was not significantly impacted, the TRs demonstrated pro-activeness and readiness to respond to such challenges. The actions undertaken by TRs included communication to clients, additional testing of the systems and re- prioritisation of the projects which would consume capacity of the systems necessary to deal with increased volatility.

2.2.6 Cyber risk and security review

104. In the last quarter of 2015, ESMA launched a thematic review across TRs in order to assess the current state of the cyber security risk environment, as it is perceived by the TRs, as well as the current defence mechanisms and capabilities that have been employed by the registered TRs to protect their data from cyber-attacks.

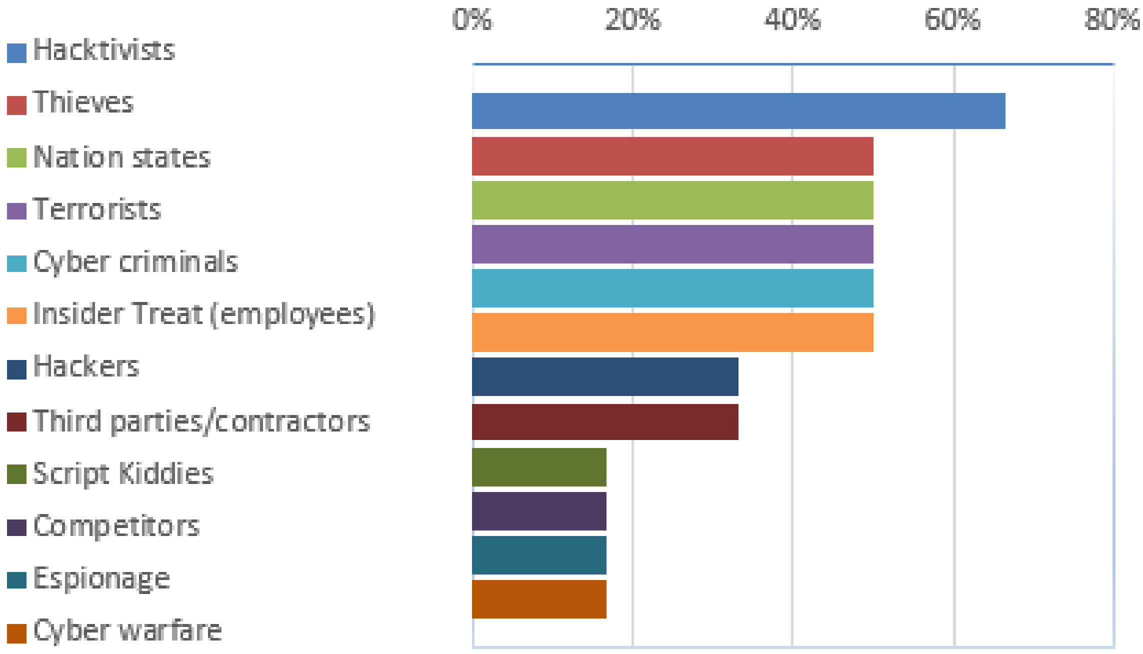
105. More specifically, the TR cyber security review was setup around the following key goals and objectives:

- to better understand the cyber risk and threat environment within which the TRs operate;
- to explore how the TRs' perception of cyber risks compared to ESMA's view;
- to explore the TRs' perception of relative importance and criticality among the various subsets of TR data (e.g. transaction, position, reference, billing data, etc.);
- to identify high level gaps in the TRs' control environment, (i.e. cases where it was evident that due care was not taken or controls deviated significantly from industry practices); and
- to identify areas where subsequent follow-up activities should be performed either because existing practices were not clear or because the information collected was not sufficient to allow for supervisory assessment.

106. A questionnaire has been prepared and sent to TRs in order to collect relevant information on the TRs' perception of potential cyber risks and threats, the importance and criticality of TR data and also the controls and mechanisms put in place to mitigate these risks.

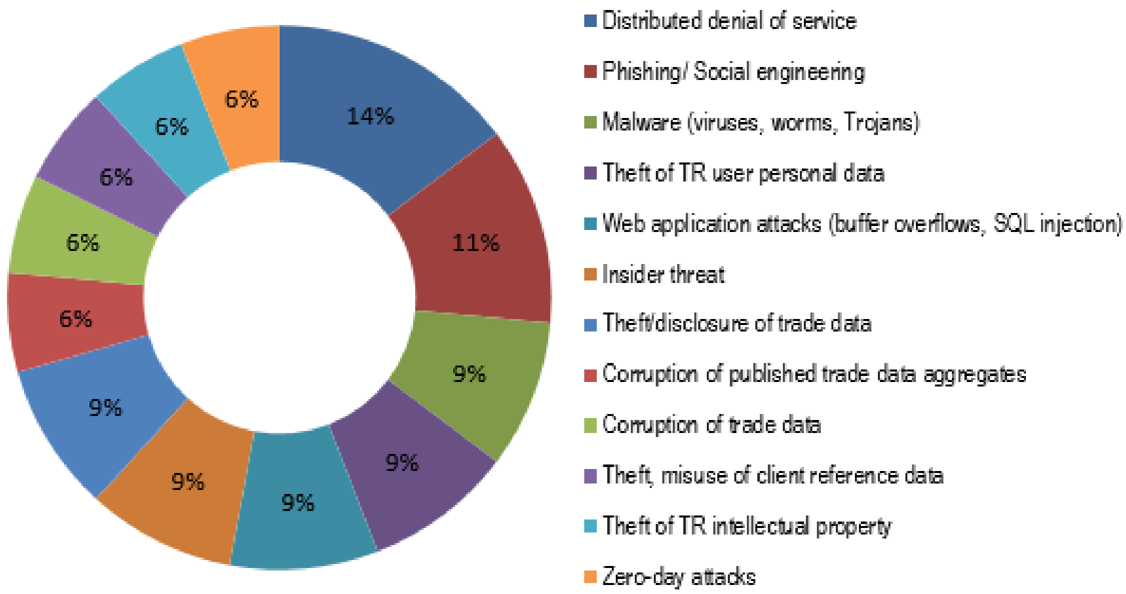
107. The following figures provide a representation of some key elements that set the frame for the description of the cyber risk and threat environment within which TRs are operating.

Figure 6 - Most significant threat agents



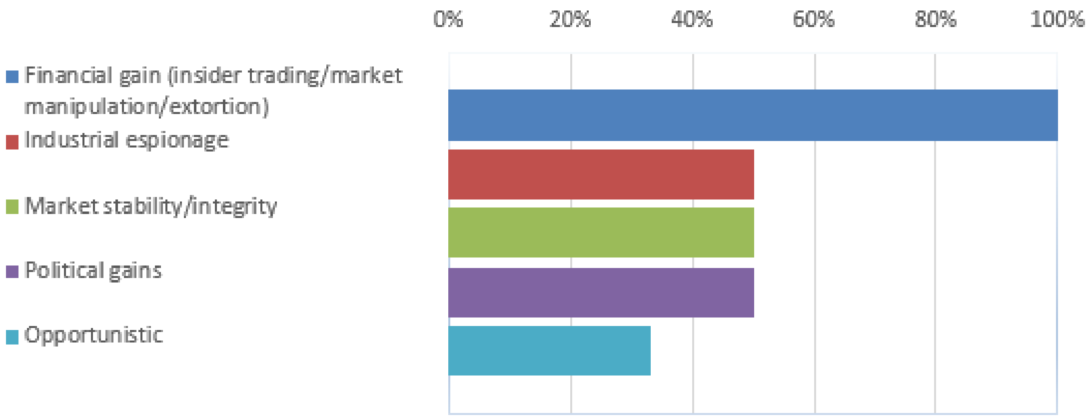
Source: ESMA supervisory data

Figure 7 - Most probable and relevant cyber-threats to TRs



Source: ESMA supervisory data

Figure 8 – Top 5 incentives for attacking TRs



Source: ESMA supervisory data

108. With regard to the control environment of TRs and the mechanisms employed to defend against cyber-attacks, ESMA has identified follow-up activities and next steps: the mitigation of potential cyber risks that TRs may face, the alignment of TRs cyber security programmes with international initiatives and guidance, and the raising of awareness of relevant stakeholders.

2.3 First Trade Repository enforcement case

109. In 2016, ESMA took its final decision in an enforcement action against DDRL. This was the first time ESMA has taken enforcement action against a TR. DDRL's IT systems performance played an important role in the infringements that were identified. During 2014, ESMA's supervisory team became aware of delays in providing regulators with access to data reported to DDRL under EMIR. The matter was referred to an IIO (independent investigations officer) who upon conclusion of his investigation, put his findings before ESMA's Board of Supervisors.

110. During the registration process, DDRL committed to provide regulators with access to relevant reported data on the first working day after the data was reported to it. However, ESMA found that DDRL failed to provide direct and immediate access to derivatives data from 21 March 2014 to 15 December 2014, a period of approximately nine months in which access delays increased from two days to 62 days after reporting and affected 2.6 billion reports. This was due to DDRL's negligence in: (i) failing to put in place data processing systems that were capable of providing regulators with direct and immediate access to reported data; (ii) failing, once DDRL became aware, to inform ESMA in a timely manner of the delays that were occurring; and (iii) taking three months to establish an effective remedial action plan even while delays were worsening.

111. DDRL's failures caused delays for regulators in accessing data, revealed systemic weaknesses in its organisation, particularly its procedures, management systems and internal controls and negatively impacted the quality of the data it maintained. Based on the provisions of Article 73 of the EMIR Regulation, in March 2016, the ESMA Board of Supervisors issued a public notice in respect of the infringements found to have been

committed by DDRL and imposed a fine of €64,000 for negligently failing to put in place systems capable of providing regulators with direct and immediate access to derivatives trading data.

3 Credit Rating Agencies

3.1 Industry state of play

3.1.1 Introduction

112. ESMA's risk assessment comprises an assessment of industry and entity level risks. The market environment in which CRAs operate has an important impact on their behaviour and risk profile. Not only issuance levels but also geopolitical developments can impact CRAs' business and way of operating. ESMA's analysis of the market dynamics is largely based on a review of political, competitive, regulatory, and technological developments, which shape or affect their business and revenue-generating ability. This market-level or top-down approach enables ESMA to assess the developments of supervised entities within the prevailing market dynamics, whether entity-specific or across several entities.

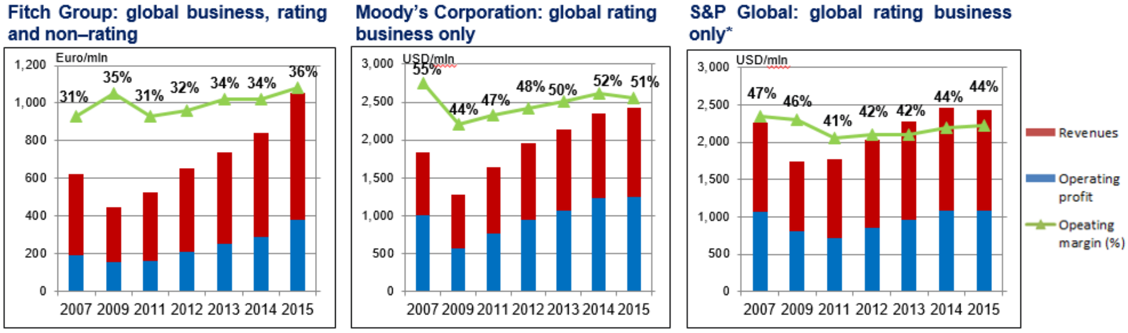
113. ESMA's entity-level supervisory review concentrates on assessing whether CRAs are able to cope with potential negative impacts stemming from the external environment and whether the CRAs' internal arrangements do not compromise the quality of credit ratings. This bottom-up approach addresses several entity-specific dimensions such as governance, business model, operational and environmental risks.

3.1.2 Competitive dynamics & credit trends

114. In 2016, ESMA supervised 26 registered CRAs[10] and four certified CRAs. However, the CRA industry in the EU remains concentrated around three large players. ESMA notes that revenue-generation capacity and overall operating margins for the largest CRAs operating globally have now fully recovered from the crisis (Figure 9). The picture is different for the smaller players, which do not have the same market position as the largest CRAs operating globally that have a longer track record and cover all asset classes (Table 1). ESMA has observed that the current economic and credit conditions have triggered strategic business decisions to change operating models, achieve critical size through consolidation and diversify the product offering and geographical presence.

[10] See full list of registered certified CRAs on ESMA's website: https://www.esma.europa.eu/supervision/credit-rating-agencies/risk. The groups of the three largest CRAs operating globally consist of 17 separate entities, so the total number of CRAs registered with ESMA is 40.

Figure 9 - Changes in the revenues, operating profits, and operating margins of the largest CRAs operating globally



ESMA elaboration based on published consolidated accounts (figures from Fitch Group based on Fimalac's consolidated annual reports).
** The 2014 figures for S&P Global do not take into account the impact of US legal and regulatory settlements on the group's operating profit and margins.*

Table 1 - Total number of outstanding credit ratings in the EU by rating type

Rating Category	Issuer	Financial instrument
Corporate non-financial	28,919	14,918
Corporate financial	6,717	55,420
Corporate insurance	1,035	750
Sovereign	1,157	8,294
Structured finance	11	10,311
Total outstanding	**37,839**	**89,693**

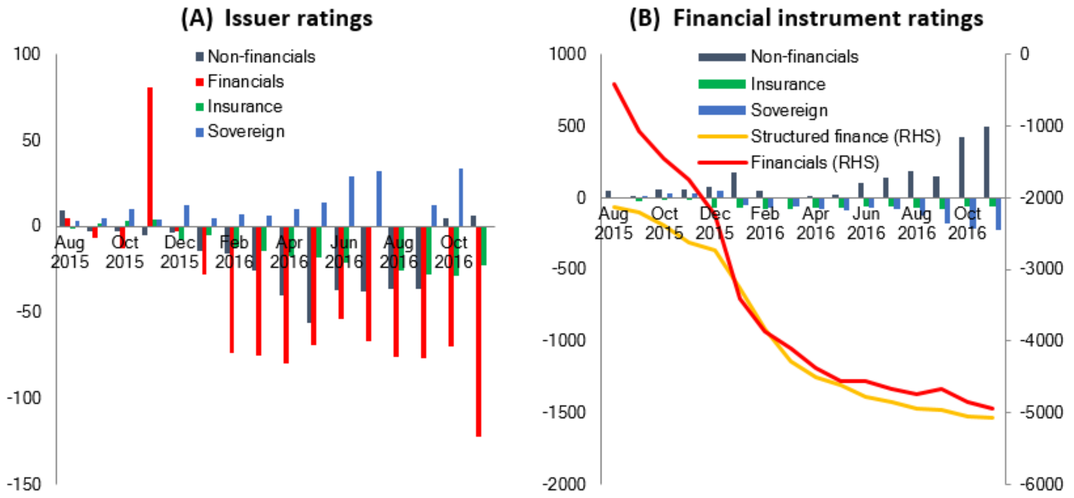
Source: Radar, ESMA

Note: Total number of credit ratings assigned to EU issuers per asset class, issuer and instrument (i.e. bond). Long term ratings only, both foreign and local currency ratings included. As of November 2016.

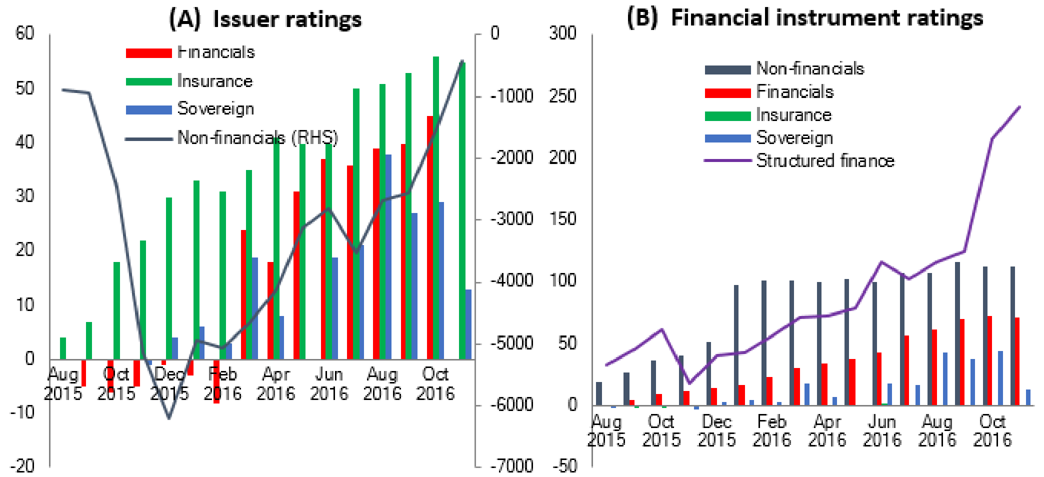
115. European credit markets have recorded a relatively benign year where issuance across asset classes reached levels equivalent to those of the previous year (Figure 10). The key drivers of these trends were on the one hand the slight improvement in macro-economic conditions on the continent and on the other hand more accommodative monetary policy (i.e. ECB's asset purchase programmes). Some of the political turbulence during the past year (i.e. UK referendum and the US elections) has not yet had a clear impact in terms of the level of issuances. At the same time, some Southern European economies (Greece, Italy, Portugal, and Spain) still face difficult conditions.

Figure 10 - Cumulative sum of net new ratings assigned in EU by asset class

S&P, Moody's and Fitch



All CRAs excluding S&P, Moody's and Fitch



Source: Radar, ESMA

Note: Cumulative sum of new credit ratings per asset class, issuer and instrument (i.e. bond). Net of withdrawals. Long term ratings only, both foreign and local currency ratings included. As of November 2016.

116. Faced with overall limited growth prospects in revenues coming from credit-rating activities, the largest CRAs operating globally aim to reduce operational costs and look for other revenue sources. ESMA observes that CRAs are expanding their offer of ancillary services and optimising the revenue-generation from existing rating relationships, and also overhauling internal organisational structures (analytical, internal control, and support functions) to reduce their cost base. At the same time, smaller CRAs are looking for more revenue generation by enlarging their coverage or by expanding into new markets. In either case, these developments can create risks, for example potential conflicts of interest emanating from ancillary services being offered to existing clients of

CRAs but also lack of expertise of staff to rate new asset classes and adequacy of the internal control structure to match an expanded business.

3.1.3 Portfolio risk

117. ESMA's portfolio risk assessment measures—by use of statistical means—the ability of a credit rating to rank in order issuers by relative credit risk. In addition, ESMA monitors large positive or negative shifts in ratings at asset class and individual entity level. From a supervisory perspective, ESMA's risk assessment tends to focus on specific movements in ratings and large changes in credit rating distributions. Large rating changes in either direction are not in themselves an indication that the regulatory requirements have been breached. However, these movements and shifts do indicate a drastic change in a CRA's opinion which trigger the need for ESMA to ensure that such movements were driven by a sound and independent rating process.

118. ESMA assesses portfolio risk as still relatively high across all CRAs and, more specifically, among the largest CRAs operating globally. The magnitude of rating shifts may differ across asset classes and across CRAs. In the aftermath of the financial crisis ESMA observed that the largest CRAs operating globally embarked on a comprehensive revision of their rating methodologies, across all asset classes. These revisions were triggered by different factors including a need to increase transparency in the market, to take into account the lessons from the crisis and to reflect more fundamental patterns at industry- or product-level. Such a trend is now also increasingly visible in smaller CRAs. Therefore, ESMA looks into the rationale for the changes to ensure that they are made in accordance with the regulatory requirements (e.g. properly validated and not conflicted by any business interest).

3.2 Supervision

3.2.1 Key risks and priorities identified for 2016

119. Based on its risk assessment, and as set out in its 2016 supervision work plan for CRAs[11], ESMA focused its supervisory activities for 2016 on ensuring that CRAs compete and develop their business in compliance with the CRA Regulation, in particular with respect to:

- governance and strategy; and
- the quality of credit ratings and credit rating activities.

120. Within these general areas, ESMA identified a number of key themes on which it focused over the year, which are described in more detail below. In addition, ESMA spent significant effort on the development of supervisory tools as described in Chapter 1.

[11] See pages 47 through 49 of the Supervision work plan for 2016 for CRAs: https://www.esma.europa.eu/sites/default/files/library/2016-234_esma_2015_annual_report_on_supervision_and_2016_work_plan.pdf

Where necessary due to ad hoc events or information received, and in line with its risk-based approach, ESMA reprioritised issues to focus on the highest risk areas. Examples of ad hoc events that resulted in a reprioritisation were the UK referendum, the merger between two CRAs and the occurrence of a potential conflict of interest situation within a CRA. ESMA also needs to dedicate resources to general supervisory activities, including for example the development of RADAR, applications for registration and complaints.

3.2.2 Governance and strategy

121. Strategic decisions taken by CRAs play an important role in changes to their corporate and governance structures. More aggressive business strategies of supervised entities led ESMA to supervise intensively, notably the smaller CRAs, to ensure growth plans are coupled with sufficient resources for the CRAs' analytical, compliance and internal review functions. ESMA also monitored business expansion to ensure that CRAs maintained an effective internal control structure at all times.

122. The wide-ranging work that ESMA performed in 2015 regarding CRAs' business development processes and, more specifically, the independence of the credit rating process and the fees charged for credit ratings and ancillary services was continued in 2016 through a number of more specific work streams and projects. The supervisory actions described below were driven by the overall high level of governance and strategy risk identified by ESMA during the 2015 risk exercise and issues that occurred over the course of the year.

Independence of the rating process

123. A key part of the CRA Regulation is the independence of the rating process from any conflict of interest or business relationship. Over the course of 2016, ESMA followed up on several supervisory issues concerning actual or potential conflicts of interest. In this respect, ESMA notes that CRAs should take all necessary steps to ensure that the issuance of credit ratings is not affected by conflicts of interest. As a consequence, sound management of those conflicts should be of paramount importance for CRAs.

124. CRAs should take a rigorous and consistent approach when an actual or potential conflict occurs, in line with the relevant provisions of the Regulation. In particular, CRAs should ensure that actual or potential conflicts of interest are disclosed to market participants in a timely manner. Affected ratings should be reviewed as soon as possible, by for example rating committees when CRAs have those. In dealing with (potential) conflicts of interest, CRAs should take into consideration the broader objective of investor protection, by among others ensuring timely transparency to the market.

125. In order to safeguard their rating process from conflicts of interest, CRAs need to comply with the organisational arrangements set out in Annex I Sections A and B of the CRA. In light of the importance of this topic, in 2016 ESMA undertook a number of specific actions to strengthen the independence of the credit rating process.

126. ESMA performed a dedicated investigation into one CRA regarding potential conflicts of interest. The investigation focused on conflicts of interest presented by the shareholders

of the relevant CRA. In addition, the investigation looked into the internal control framework of the CRA.

127. ESMA found that a number of key areas should be improved. First, as the CRA faced situations where a (potential) conflict of interest existed, it should not have issued new credit ratings related to the entity or issue affected by this conflict. In addition, the CRA did not have an effective control structure in place to address (potential) conflicts of interest. Finally, the compliance function of the CRA failed to advise the organisation on how to identify, eliminate, or manage and disclose, potential and actual conflicts of interest and to raise the awareness of analysts in this respect.

128. During 2016 ESMA also continued its monitoring of smaller entities' internal organisational structure and interaction with key shareholders and parent companies. ESMA acknowledges there is no one-size-fits-all model to prevent or address (potential) conflicts of interests, and organisational arrangements may therefore be specific to each CRA. ESMA does monitor the effectiveness of the arrangements put in place by CRAs, notably the potential involvement of senior management in the process of preparing and issuing credit ratings. The combination of a shorter track record, smaller organisational structures, lower financial means, and focus on ensuring their viability or success may heighten the risk that analytical and commercial objectives are not sufficiently separated within smaller CRAs.

129. ESMA continued its dialogue with smaller entities to enhance their understanding of the CRA Regulation and ensure that these entities adjust their organisational arrangements to comply with the regulatory requirements. For instance, ESMA focused on the clear and effective separation of key senior management positions from internal control functions, such as the methodology review function.

130. As part of a remedial action plan following an investigation into one CRA, ESMA also required a CRA to enforce in practice its policies of clearly separating commercial and analytical functions, notably to avoid that new analysts joining the CRA become too involved in commercial outreach at the expense of their analytical duties. With a view to support the CRA in implementing remedial actions following the investigation, ESMA organised an all-staff town hall meeting with this CRA covering the main areas of the remedial action plan. The meeting was aimed at engaging with the CRA beyond its managerial level and increase staff awareness regarding ESMA's expectations in terms of the agreed upon remedial actions.

131. In 2016, ESMA continued to pay attention to entities where it identified the independence of rating activities could be jeopardized by shareholder interference. In such cases, ESMA focused on strengthening the role and composition of various boards and committees within CRAs, and reminded INEDs of their duties to act as an independent safeguard to fend off shareholder interference. In a specific investigation, ESMA requested a CRA to ensure that its majority shareholder would focus on group strategy setting and let go of any operational responsibility at the rating subsidiary.

132. In its 2015 annual report, ESMA stated that it had identified a number of cross-shareholdings in CRAs following work performed on their ownership structures, and the

shareholdings of CRAs and their board members in rated entities and related third parties. Cross-shareholdings are prohibited under certain circumstance (Article 6a of the CRA Regulation). In 2016, ESMA oversaw the resolution of such a cross-shareholding in a CRA.

Growth, competition and strategy

133. The trend observed in 2015 regarding important changes that CRAs were making to their corporate and governance structures continued in 2016. ESMA has seen a number of instances of changes in ownership and shareholders and has observed consolidation and some strategic initiatives among the smaller entities in the industry (as set out in Section 3.1.

134. ESMA has closely monitored these developments and the impact they have on CRA operations and internal control frameworks. In this respect, ESMA encourages senior management of CRAs to always take a comprehensive approach to strategic initiatives and also look at adequate resourcing of compliance, internal audit and other control functions when considering expansions. In addition, in a changing environment it is of the utmost importance to have a consistent compliance-oriented message coming from senior management.

135. The consolidation concerned the acquisition of a registered CRA by the parent company of another. This was the first time ESMA was confronted with such a situation, which provided an important test for the CRA regulation and supervisory practices. The transaction reflected many of the dynamics currently at play in this segment of the CRA industry as described in Section 3.1. From a supervisory standpoint, ESMA stresses the need for CRAs, board members and other key functions within CRAs to proactively reach out to ESMA at an early stage regarding important strategic and governance changes in order to understand and address any supervisory concerns that ESMA may have.

CRAs' Boards and INEDs

136. The boards of registered CRAs play a key role. Therefore, ESMA interacts with board members on a regular basis. ESMA has started to meet with the entire board of some CRAs on an annual basis and will continue this practice going forward. Such interactions provide a good forum to discuss key developments within the market for credit ratings and address supervisory issues or concerns.

137. Within the governance requirements that apply to CRAs according to the CRA Regulation, an important role is given to INEDs. At least one third, but no less than two, of the members of a CRA's board have to be independent members. The CRA Regulation has assigned special responsibilities to INEDs which include the requirement to monitor and provide opinions to the board on the development of credit rating policy and methodologies, the CRA's compliance and governance process, the effectiveness of the CRAs' internal control functions and the policies and procedures regarding conflicts of interest.

138. ESMA has continuously highlighted the importance of INEDs and the valuable role they play within CRAs' governance. Following the roundtable for INEDs that ESMA organised

in November 2015, ESMA sent a letter to INEDs and CEOs of CRAs, which provided further guidance regarding the INEDs' role in a CRA. Over the course of 2016, ESMA has continued its dialogue with INEDs and their role within CRAs. ESMA stresses the need for proactive communication from CRAs regarding important changes in their business, operations or other supervisory issues. In this respect, INEDs also have an important role to play in the interaction with ESMA on such matters.

139. According to the CRA Regulation, INEDs can only serve one five-year mandate, which cannot be renewed. As the CRA Regulation has been in force for a little over 5 years, ESMA has seen significant turnover of INEDs over the last year. Most CRAs that were confronted with resigning INEDs have taken a sensible approach in this respect by staggering the appointments of new INEDs to ensure continuity and adequate handover.

140. Other good practices that ESMA identified have been the appointment of INEDs despite an exemption being applied, the induction training that is provided to new INEDs and the possibility for INEDs of the EU registered entities to meet with board members of other companies within the same group. ESMA typically interviews potential INEDs to ensure they have an understanding of the CRA Regulation and their specific role and responsibilities entailed therein. In order to build a good supervisory relationship with INEDs, ESMA regularly meets with INEDs to discuss recent developments and concerns and issues that might be of mutual interest.

141. Over the course of 2016, ESMA has also observed differing practices among INEDs. ESMA is supportive of active involvement of INEDs, provided it does not lead to INEDs performing a role that resembles that of executives and jeopardizes INEDs' independence. ESMA noted that the line between executive and non-executive roles were at times blurred, especially in smaller entities, therefore causing the risk that a hands-on attitude turns into a potential conflict of interest situation.

Internal Controls

142. As part of its priorities for 2016, ESMA examined the role of internal control functions and in general of the internal control system in supervised entities, and how this would link with the various regulatory requirements in the CRA Regulation.

143. Specifically, CRAs need to identify and establish effective internal control arrangements, as well as to monitor and evaluate the adequacy and effectiveness of its systems, internal control mechanisms and arrangements and take appropriate measures to address any deficiencies. In view of the importance of internal controls in meeting the objectives of the CRA Regulation, ESMA has started developing a framework, with a view to establish a set of leading practices around internal control for its supervised entities. This framework draws on ESMA's experience over the past years and aims to provide guidance to supervised entities on several aspects including organisational structure.

144. Another important issue in this respect is internal control culture. ESMA would like to stress the importance of establishing an internal control culture top down effected from the Board and Senior Management and work towards improving and/or maintaining an effective internal control system, regardless of the size and complexity of the

organisation. ESMA will continue its activities in this regard in the coming year (see Section 5.4) as the organisational implementation of the internal control framework is a key foundation of the governance of CRAs and plays an important role in ensuring that the quality of ratings is continuously monitored, improved, and ultimately guaranteed. ESMA will start interacting with supervised entities on the framework developed and its main components in the course of 2017.

3.2.3 Quality of ratings

145. The other main area of focus for 2016 was the quality of ratings issued by CRAs. ESMA has focused on a number of aspects including (the validation of) credit rating methodologies, the analytical function, and the disclosure of rating actions and methodologies. These matters are at the heart of the rating process and will continue to be an area of focus for ESMA in the coming years.

146. ESMA has also carried out further work on the outcome of the IT risk assessment that was completed in 2015. In light of the importance of IT processes and applications supporting of the rating process and the growing importance of information security, ESMA will carry out further work in this area in 2017. Cyber security is an example of an area where ESMA conducts work on both CRAs and TRs, which allows for important synergies.

Methodologies and analytical function

147. The investigation into the validation and review of methodologies was one of ESMA's main activities regarding the quality of ratings in 2015. In 2016, ESMA monitored the implementation of the remedial actions that were agreed with the individual CRAs. The remedial actions focused on the methodology review and validation process, the documentation of the annual review of methodologies including their results and the independence of the methodology review function from other functions as required by the CRA Regulation.

148. Following the investigation into the validation and review of methodologies, ESMA also identified the need to set standards for the use of quantitative and qualitative techniques throughout the CRA industry, especially where there is limited quantitative evidence available. Therefore, ESMA worked on a set of guidelines on the validation and review of CRAs' methodologies, which were published in November 2016 (Validation Guidelines).[12] In 2017, the implementation of the Guidelines by CRAs will be one of ESMA's key areas of supervisory attention.

149. ESMA also monitored the implementation of some final remedial actions regarding the investigation into the monitoring and review of credit ratings on structured finance instruments. These actions required significant effort from CRAs with respect to, for

[12] For more information see https://www.esma.europa.eu/sites/default/files/library/2016-1575_final_report_on_guidelines_on_the_validation_and_review_of_cras_methodologies_4.pdf

example, the implementation of IT tools and systems to ensure consistency of the rating process for both the issuance of new credit ratings and the monitoring of existing ones.

150. In 2016, ESMA also used a range of supervisory tools and statistical methods to examine the quality and accuracy of credit ratings issued by CRAs and to assess whether CRAs are complying with the requirements of the CRA Regulation regarding methodologies, models and key rating assumptions. On the basis of the information acquired, ESMA has identified a number of rating actions of several CRAs that are currently or will be investigated further. ESMA will report on the results of these investigations when concluded.

151. Regarding the disclosure of methodologies and rating actions, ESMA ensured that enhancements were made to the disclosure process of methodologies, models and key rating assumptions as well as any material changes. Following an investigation in 2015 on a small CRA and the resulting remedial action plan, ESMA will continue to monitor the implementation of remedial actions by this CRA in 2017. Key areas of focus are enhancement in the disclosure of methodologies for a specific asset class, improvements in rating process consistency for both new issuance and surveillance activities, as well as implementation of IT tools and systems to support the remedial actions.

152. Following the investigation into the process of issuing credit ratings by one CRA on which ESMA reported in 2015, an extensive remedial action plan was agreed. The work of ESMA in 2016 focused on remedial actions that clearly defined the roles and responsibilities of the analytical function (as opposed to support staff) and sufficiency of analytical resources. In addition, as result of a dedicated follow-up investigation focussing specifically on the CRA's linked credit rating practices, ESMA asked for improvements to the analytical robustness, the controls and the recording of its linked credit rating practices. As part of another investigation into a CRA, ESMA influenced the CRA to change its organisational arrangements so as to ensure the independence of the methodology review function and to prevent business interests from potentially influencing credit rating activities.

153. Pursuant to Article 14(3) of the CRA Regulation errors made in the application of methodologies and material changes to methodologies need to be notified to ESMA. ESMA assesses these notifications by CRAs and follows up where necessary. Over the course of 2016, CRAs reported more than 120 errors to ESMA and over 80 changes in methodologies. Although the majority of errors made by CRAs in the application of their methodologies do not have an effect on the credit ratings issued, ESMA is concerned by the number of errors reported by CRAs over the course of 2016. Therefore, in 2017, ESMA will continue to closely monitor this trend and take supervisory actions where necessary and appropriate.

Rating process

154. A number of CRAs have started redesigning their entire rating process, including automating large parts of the process, from data collection to publication. As the controls around the rating process play a key role in the outcome of the rating process and the

quality of ratings, this will be a key area of supervisory attention for ESMA in the coming years.

155. Besides its monitoring activities in this area, ESMA also performed investigations on the adequacy of the rating process. An example is the investigation into the process of issuing credit ratings by one CRA mentioned above, during which the assignment of credit ratings on individual debt issuances was sometimes found to be too mechanical or to lack sufficient analytical input. Over the course of 2016, ESMA monitored the implementation of the remedial action plan by the CRA in question.

156. As a follow-up to this investigation, ESMA performed another investigation into the process to assign “linked credit ratings” by one CRA. For the purpose of this investigation ESMA defined “linked credit ratings” as ratings on issues or issuers that are dependent on other ratings or asset collateral. The investigation focused on the comprehensiveness of the analytical assessment of these ratings and the respective controls and record-keeping procedures that apply to the rating process for such ratings. This investigation raised a number of concerns regarding the rating process.

157. ESMA would like to stress that the rating process for all credit ratings, including “linked credit ratings”, should comply with the quality standards and objectives of the CRA Regulation. This includes updating or changing “linked credit ratings” when this is required by the applicable credit rating methodology, applying appropriate record-keeping procedures and having an effective system in place for identifying rating errors.

Information Technology and Information security risk and controls

158. In view of their dependence on IT infrastructure, IT internal controls and information security play a fundamental role in CRAs. This role is visible in the entire rating process, from the input of data to the final publication of credit ratings, in ensuring confidentiality, integrity and availability of the rating data, the process and the methodologies used. Therefore, it is crucial that CRAs identify and implement effective IT internal controls and information security controls, as well as monitor their effectiveness.

159. In 2016, ESMA finalised the IT risk assessment on the largest CRAs initiated in 2015, and communicated the results to the relevant CRAs, informing them of the high risks in the areas of IT internal control and information security. This exercise was meant to improve ESMA’s understanding of the risks associated with the largest CRA’s IT environment and to inform ESMA’s supervisory strategy regarding IT internal controls and information security controls. Overall ESMA identified high risk areas related to IT governance, information security, IT operations and project management, as well as risk management and internal audit structures and processes.

160. ESMA took note of the actions some of the CRAs had already started implementing following the IT risk assessment reports, and encouraged CRAs to take the findings on board and start addressing the identified risks. At the same time, ESMA has observed that in some CRAs risks, that had been identified, have materialised and also that concerns raised had persisted, without appropriate remediation taking place. Therefore, ESMA will follow-up on these issues in 2017, as described in Section 5.4.

3.2.4 General supervisory activities

161. Over the course of 2016, ESMA received one application for registration as a CRA. At the same time, ESMA still frequently receives expressions of intention to apply for application. The application received by ESMA was refused. In ESMA's experience over the past years, applications are often refused due to applicants not meeting the requirements regarding:

- internal controls;
- independence and avoidance of conflicts of interest; and
- methodology, models and key rating assumptions.

In line with the approach of CRAR, which grants the possibility for small CRAs to apply for an exemption of certain onerous requirements, ESMA takes a proportionate approach to applications of small CRAs. Nonetheless, all CRAs should ensure that the minimum requirements of CRAR are met at the time of registration.

162. As part of its supervisory activities for CRAs, ESMA continuously carries out perimeter assessments, i.e. identifying entities which may be issuing credit ratings without registering as a CRA. Entities who want to issue credit ratings need to be registered with ESMA. The issuance of credit ratings is governed by the CRA Regulation and is designed to enhance investor protection, ensure orderly markets by creating a level playing field for all entities issuing credit ratings in the EU, and contribute to financial stability.

163. In its perimeter work, ESMA assesses whether market services and products fall under the definition of a credit rating or constitute credit rating activities under the CRA Regulation and if these services or products are covered by any exemption of the CRA Regulation. ESMA uses a variety of information sources including market participants, NCAs and ESMA's own assessments (e.g. periodic internet sweeps), to identify companies potentially providing credit rating activities. Throughout 2016, ESMA has requested information from several companies, including a number of financial intermediaries, to assess whether their investment research or investment recommendations activities fall within the scope of the CRA Regulation.

164. Another important source of information for ESMA's supervisory activity are complaints received by market participants or other stakeholders. Over the course of 2016, ESMA received complaints regarding CRAs on a variety of topics. ESMA can usually not comment on the actions that it takes towards supervised entities following the receipt of complaints due to the confidential nature of discussions between ESMA and supervised entities. However, ESMA treats every complaint with due care and encourages participants to reach out to ESMA with supervisory issues by using the complaints form available on its website.[13]

[13] See https://www.esma.europa.eu/about-esma/esma-in-short/complaints

165. ESMA encourages issuers and users of credit ratings and other services provided by CRAs to continue engaging with ESMA on these and other relevant topics as these interactions form a key source of information for ESMA. Where necessary, ESMA also reaches out proactively to issuers to understand their point of view on the conduct of CRAs.

166. In order to achieve its supervisory objectives and due to the global nature of the larger CRAs' operations, cooperation with other supervisory authorities is an important aspect of ESMA's supervision. Therefore, ESMA is actively participating in the global supervisory colleges, which consist of ESMA and the main CRA regulators outside the EU for the three largest and internationally operating CRAs. The supervisory colleges facilitate information-sharing and cooperation between supervisors operating in different jurisdictions. In addition to its participation in the supervisory colleges in 2016, ESMA also interacted on a bilateral basis with regulators outside the EU to inform its supervisory activities on specific topics including conflicts of interest, internal controls, the adequacy of the validation of methodologies and the role of the compliance function.

167. Over the course of 2016, ESMA continued its work on the implementation of RADAR, the IT system that is necessary to establish the ERP required by Article 11(a) of the CRA Regulation. Through RADAR, CRAs are providing ESMA with information on credit ratings and pricing practices and fees charged for these credit ratings and ancillary services. ESMA started receiving actual data from CRAs at the end of March 2016.

168. Material changes are notified to ESMA on an ongoing basis. One of the requirements for CRAs is to formally notify ESMA in a timely manner of any material changes to the conditions of their initial registration. Over the course of 2016, ESMA was notified of more than 50 material changes, which related to a variety of topics including changes in ownership as described above, changes to senior staff, compliance officers or board members, the opening of new branches, coverage of new asset classes and changes in policies and procedures.

169. Following a first assessment of the notification, ESMA may ask for further information if it cannot complete the assessment based on the information provided. In case of changes to senior staff and compliance officers, ESMA usually engages with the candidates to better understand their qualifications, roles and responsibilities and provide background information on ESMA's supervision of CRAs where necessary. ESMA notes that the quality and timeliness of the information provided varies significantly from one CRA to another, and even depending on the type of changes being reported. ESMA continuously interacts with CRAs to increase the quality and timeliness of the information provided and will continue to work on this in 2017.

170. Receiving good quality information is key for ESMA in order to be able to conduct its supervisory activities. Therefore, ESMA spent significant resources on the implementation of a data quality action plan that consists of the validation of qualitative and quantitative data for credit ratings and fees data received through RADAR. This required close cooperation with the CRAs to ensure that the data reported to ESMA was both representative of CRAs' business activities and fit for supervisory purposes. The

information reported through RADAR will allow ESMA to further refine its supervisory approach to CRAs as it will receive more granular information on credit ratings, ancillary services and fees charged for these activities. More information on ESMA's work on supervisory tools is provided in Chapter 1.

171. On 1 December 2016, ESMA launched the ERP to provide access to free, up-to-date information on credit ratings and rating outlooks.[14] The ERP is an important element in ESMA's work, following the financial crisis, to increase transparency around credit ratings and help investors make informed decisions. In providing granular information on specific rated entities and instruments to the general public, the ERP complements the statistical data on CRAs' rating activities and rating performance which ESMA already publishes via its central repository database (CEREP).

3.3 Enforcement

172. In 2016, ESMA has taken one enforcement decision regarding Fitch. The enforcement decision related to a number of breaches, including a failure to comply with the 12 hour requirement, a lack of sound internal controls around this requirement and unauthorised disclosures of sovereign rating changes.

Failure to comply with the 12-hour requirement

173. On 26 January 2012, Fitch informed the representatives of Slovenia of its intention to downgrade the sovereign rating for Slovenia, without offering any information on the grounds for the intended downgrade. Only on the following day did Fitch send that information to Slovenia's representatives who, in reply, informed Fitch that, in accordance with the CRA Regulation, they expected to be granted 12 hours from the time of receipt of Fitch's information on the grounds for the intended downgrade in order to assess the information provided. This requirement to allow time ('the 12 hour requirement') aims at giving the rated entity an opportunity to point out any factual errors to the CRA.[15]

174. However, rather than waiting the necessary 12 hours, Fitch proceeded with the public announcement of the downgrade approximately 3 hours after providing the grounds on which its rating action was based. The ESMA Board of Supervisors found therefore that Fitch had committed an infringement under the CRA Regulation in failing to comply with the 12 hour requirement. The Board found this infringement was committed negligently and accordingly fined Fitch €60,000 for this breach.

Lack of sound internal controls to support compliance with the 12-hour requirement

175. ESMA's Board of Supervisors found that between 1 June 2011 and 14 February 2012, Fitch's internal controls for the purpose of complying with the abovementioned 12-hour requirement of the CRA Regulation were affected by substantial shortcomings:

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[14] https://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_radar

[15] The time period included in this provision was extended to a full working day by Regulation (EU) No 462/2013.

- the policy framework provided unclear guidance to staff on how to comply with the 12-hour requirement;
- those responsible for supervising compliance with the 12-hour requirement within the sovereign and international public finance group did not exercise their control functions;
- the internal control functions did not detect this absence of internal controls; and
- follow-up action taken by the internal control functions did not detect and adequately address the above shortcomings.

176. Thus, ESMA's Board of Supervisors found that, for the abovementioned period, Fitch committed an infringement under the CRA Regulation in failing to have e sound internal controls. The Board found this infringement was committed negligently and fined Fitch €825,000 for this breach.

Unauthorised disclosure of new and potential new sovereign rating changes

177. ESMA's Board of Supervisors further found that, from 1 December 2010 to 7 June 2012, senior analysts in Fitch transmitted information about upcoming rating actions on sovereign ratings to senior persons in Fimalac S.A., the parent company of Fitch at that time. The CRA Regulation prohibits disclosure of information on upcoming rating actions to persons other than those involved in the production of the relevant credit ratings or to the rated entity. In the period concerned, there were nine separate sets of email exchanges concerning actual or potential upcoming rating actions relating to six countries - Greece, France, Ireland, Italy, Portugal and Spain. Thus, ESMA's Board of Supervisors found that by these prohibited disclosures Fitch had committed an infringement under the CRA Regulation.[16] Moreover, the Board found this infringement was committed negligently and therefore fined Fitch €495,000.[17]

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[16] Due to the timing of the entry into force of the relevant infringement provisions, the Board was limited to finding an infringement in the period between 1 June 2011 and 7 June 2012.

[17] Further information on ESMA's decision concerning Fitch is available on ESMA website https://www.esma.europa.eu/sites/default/files/library/2016-1159_public_notice.pdf.

4 Common areas of supervision in 2016

178. Following the consolidation of its supervisory activities on CRAs and TRs in 2015, ESMA started using the synergies that were created through this merger of TR and CRA supervision in one department. As part of its work plan for 2016, ESMA identified two common areas of supervisory focus across CRAs and TRs: information security and fees charges by supervised entities. Joint work was performed principally in the area of fees, while the work on information security so far has remained more industry-specific and is reported on in the separate sections for CRAs and TRs below.

179. Another topic on which ESMA performed joint work is the outcome of the EU referendum. In 2016, ESMA has started looking at the impact that the UK leaving the EU may have on both CRAs and TRs. This included assessing the immediate impact of the outcome of the referendum and discussing with CRAs and TRs on the approach they are taking and potential supervisory risks identified. ESMA will continue its work in this respect in 2017 as described in Section 5.2.3.

180. As announced in the supervision work plan, in 2016, ESMA launched a project on the fees charged by supervised entities. The aim of this project was to enable ESMA to develop strategies for the effective supervision of Article 78 of EMIR and Annex I Section B Point 3c and Point 4 of the CRA Regulation.

181. Article 78 of EMIR requires access to TRs to be non-discriminatory and the fees charged by TRs to be publically disclosed and cost-related. EMIR further requires any ancillary services provided to be kept operationally separate from the trade reporting function. The CRA Regulation requires that the fees charged for the provision of credit ratings and ancillary services should be non-discriminatory and based on actual costs and that the fees charged for credit rating services should not depend on the level of the credit rating issued or any outcome of the work performed. The CRA Regulation further highlights that the provision of ancillary services must not present conflicts of interest with credit rating activities and it requires CRAs to separate commercial and analytical functions.

182. During the first part of the project, ESMA collated the information available to it through supervised entities' reporting to ESMA, its own market monitoring activities and its interactions with market participants. In general, market participants are critical about the level of fees charged by CRAs and TRs including increases in such fees. ESMA is now using its monitoring tools to obtain further information from supervised entities about the products and services provided by the groups of companies of which supervised entities form part as well as from the users of those services. This information is helping ESMA to understand how the provisions regarding access and fees have been interpreted by supervised entities and users to date and in particular, how supervised entities set the prices that they charge for the products and services they provide and how these fees relate to the costs of providing these products and services.

183. ESMA will report on the findings of this exercise through the publication of a thematic report in 2017. This report intends to highlight the industry practices observed by ESMA. It will also set out ESMA's expectations as to how supervised entities can ensure compliance with the applicable regulatory requirements regarding fees and ancillary services and how ESMA will approach the supervision of core and ancillary services in the future.

184. In addition, in 2016 ESMA has participated in important EU and international initiatives on IT internal control and information security aspects in financial supervision, including the CPMI-IOSCO working group on cyber resilience, which has published the Guidance on cyber resilience for financial market infrastructures on 26 June 2016[18]. ESMA has also closely followed the work of the EBA Task Force on IT Supervision. In addition, ESMA has been involved along with the European Commission and the ECB, in the work performed to produce the G7 fundamental elements of cybersecurity in the financial sector published by the Japanese G7 presidency on 11 October 2016[19].

5 Supervision work programme for 2017

5.1 Introduction

185. In order to establish its annual work programme for CRAs and TRs and as mentioned in Chapter 1, ESMA uses a risk-based approach. The risk assessment takes into account all the information available to ESMA, i.e. information collected from previous supervisory activities, (periodic) information reported by the supervised entities, information communicated to ESMA by NCAs, market participants and third-country regulators and information obtained through ESMA's own market intelligence.

186. ESMA's risk assessment takes into account risks at an entity level but also at an industry level. It builds on the observed market trends and current state of the CRA and TR industry in the EU. As described in Sections 2.1 and 3.1, some of the industry-level factors that ESMA has taken into account in this year's risk assessment are the competitive dynamics and credit trends, the portfolio risk, regulatory changes, and technological developments.

187. The risk assessment identified the following areas of focus for TRs in 2017

- Data quality and access by authorities;
- Technology changes and internal control; and

[18] https://www.iosco.org/news/pdf/IOSCONEWS433.pdf

[19] https://www.mof.go.jp/english/international_policy/convention/g7/g7_161011_1.pdf

- Strategy and governance.

188. The risk assessment carried out for the 2017 work programme leads ESMA to the following areas of focus for CRA supervision:

    - Quality of credit ratings;
    - IT and internal controls;
    - Strategy and governance; and
    - Risk assessment and data

The following sections provide an overview of the work that ESMA will perform in 2017 regarding these areas of focus. The overview starts with a number of areas where ESMA intends to undertake common work across both CRAs and TRs.

5.2 Common areas of focus for Credit Rating Agencies and Trade repositories

5.2.1 Internal control framework

189. ESMA intends to build on the work performed on the internal control framework in 2016 for all supervised entities, i.e. CRAs and TRs. ESMA believes that the identification and implementation of internal control arrangements and mechanisms, as required by EMIR and the CRA Regulation, should be performed through the establishment of a top-down and comprehensive internal control system. Effective compliance, governance and risk management practices are key for supervised entities to meet the CRA Regulation and EMIR provisions.

190. Therefore, the main objectives for this work would be to clarify the supervisory expectations regarding the establishment of internal controls in the supervised entities. In addition, ESMA will provide clarification on this topic to the supervised entities and monitor their implementation. At the same time, ESMA does not intend to fully harmonise internal control practices of the supervised entities, since it recognises that each organisation is different. It remains the entities' responsibility to identify effective ways to implement an internal control framework, taking into account their own environment.

191. In this context, and building on the preliminary work performed in 2016, over the course of 2017, ESMA intends to further calibrate the internal control requirements to EMIR and the CRA Regulation while considering international internal control standards and leading practices. In addition, ESMA will integrate the internal control framework with other supervisory tools to improve ESMA's risk-based approach and enhance its risk identification and monitoring.

5.2.2 Cloud computing

192. ESMA has already identified the significance of the IT infrastructure and process in the performance of the supervised entities' business activities and, therefore, the importance of implementing effective IT-related and information security controls. To cope with the increasingly demanding business requirements while minimising costs, many companies have been opting for cloud computing solutions. Cloud computing is also gradually becoming an important IT operations- and outsourcing model favoured by many of ESMA's supervised entities in both industries (TRs and CRAs).

193. ESMA understands that cloud computing can bring many benefits in the way TRs and CRAs perform their business activities, mostly related to increased scalability of infrastructure, operational efficiencies (considering the on-demand self-service capability of a cloud computing implementation), cost-effectiveness, and, in some cases, potential for an increased availability of data and business processes. At the same time, it entails certain risks and challenges, which go beyond those of 'traditional' IT outsourcing and may constitute a material change.

194. In this context, ESMA considers that it is imperative to better understand, from a supervisory perspective, the impact and risks, so that supervised entities realise the maximum potential of the cloud computing benefits, while not raising concerns regarding their compliance with regulatory requirements. Key areas of focus for ESMA relate to outsourcing, internal controls and cyber security risks. Therefore, ESMA has identified the need to work on this subject, with a view to formulate a clearer supervisory response and strategy. In order to achieve this, ESMA will perform a stock-taking on the actual cloud computing implementations in the CRA and TR industries. In addition, ESMA will identify the impact and the risks of cloud computing models from a supervisory perspective and determine its supervisory response regarding this subject.

5.2.3 Outcome of the UK referendum

195. As set out in paragraph 179, ESMA has started working on the implications of the outcome of the UK leaving the EU in 2016. This work will be continued in 2017 and include an assessment of the potential implications under different possible scenarios in relation to ESMA's objectives to enhance investor protection and promote stable and orderly financial markets. ESMA has also started engaging with CRAs and TRs that may be affected by the outcome of the referendum to understand the preparations these entities are making and how their decisions might impact on ESMA's supervisory activities and the relevant markets and entities themselves in order to ensure that potential risks are identified and managed. ESMA will continue this work in 2017.

5.2.4 Fees and ancillary services

196. Another important project for ESMA is the fees and ancillary services project. As set out above, following the completion of the first phase of the project in 2016, the information collected is helping ESMA to understand how the provisions regarding access and fees have been interpreted by supervised entities and users to date and in particular, how supervised entities set the prices that they charge for the products and services they provide and how these fees relate to the costs of providing these products and services.

197. ESMA will report on the findings of this exercise through the publication of a thematic report in 2017. This report intends to highlight the industry practices observed by ESMA and will identify possible areas of concern and follow-up in light of the objectives of the relevant regulations. Ultimately ESMA wants to set out its expectations as to how supervised entities can ensure compliance with the applicable regulatory requirements regarding fees and ancillary services.

5.3 Work programme for Trade Repositories

198. The findings of the TR risk assessment demonstrated that the main risks identified relate to TR data quality, access by to TR data by regulated authorities, anticipated technology changes, internal controls, governance related issues and the strategic direction of TRs as they navigate in a dynamic business and regulatory landscape. ESMA has already taken a number of measures regarding specific operational risks in these areas and is currently expanding its reach to include business and strategy related risks stemming from changes in the operational environment for TRs.

199. As a result of ESMA's risk assessment, the following areas of supervisory focus have been identified for 2017:

- Data quality and access by authorities;
- Technology trends and internal control; and
- Strategy and governance.

200. ESMA will follow-up and expand on its work in these areas through individual and thematic investigations, in addition to ongoing monitoring of the TR activities, risks, and controls employed.

5.3.1 Data quality

201. Data quality remains a key area of concern for both TR supervision and ESMA in general. Given the role of TRs in financial markets, data quality is a major priority from both a financial stability and investor protection perspective. While the introduction of level 2 data

content validations in late 2015 significantly improved the quality of the reported data and helped authorities to make better use of them, a more collaborative approach between ESMA, NCAs and other users of TR data is necessary to become even more effective in this area.

202. This will be achieved through the dedicated actions of the Data Quality Action Plan listed below and the recently introduced framework with NCAs that intends to increase efficiency, transparency and effectiveness of data quality actions. However, increasing effectiveness will also require in-depth and targeted discussions between TRs, ESMA, counterparties and NCAs directly. In this respect, ESMA is working directly with NCAs to improve counterparty reporting. Although NCAs supervise counterparties directly, ESMA is in a unique position of being able to analyse the whole market to identify counterparties' reporting inconsistencies across all jurisdictions, in addition to the quality of data from TRs. ESMA will continue to closely cooperate with NCAs to assist in identifying solutions for counterparties.

203. Furthermore, ESMA will also intensify its engagement with other users of data such as the ESRB, ECB and other central banks. Increased interaction with these other users will allow ESMA to gain more nuanced insight in issues that undermine the usability of TR data from both an economic and technical point of view. A better identification of issues will allow for more effective data quality improvement actions. ESMA will develop effectiveness metrics to measure the benefits attained.

204. In November 2015, ESMA submitted the draft technical standards on the minimum details of the data and the format and frequency of trade reports to be reported to trade repositories to the Commission. These have been recently published by the European Commission and are expected to be implemented in the second half of 2017.[20] A new set of data validations, aligned with the amended technical standards, will also be applied during the year. In addition, further regulatory requirements, including the guidance on portability and the revised technical standards on data to be made publicly available by TRs, as well as the second phase of the TRACE, are expected to improve data quality and access.

205. ESMA will monitor the readiness of TRs for the implementation of the amendments to the respective technical standards and projects, and will work closely with TRs and authorities to identify and resolve arising data quality issues. In particular, ESMA will continue re-validating the TR data at both Trade Activity and Trade State report levels and assessing the completeness, accuracy and comparability among TRs of these reports. Furthermore,

[20] See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0105&from=EN and http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0104&from=EN

ESMA will monitor the implementation of projects related to the harmonisation of the Inter-TR reconciliation process.

206. Additional activities to be considered, in line with the data quality improvement objective, are the necessity for additional layers of data validations and the assessment and improvement of the accuracy and usability of the supervisory-related statistical information and reports received by ESMA.

207. Furthermore, ESMA will keep working with TRs to mitigate risks regarding the access that authorities have to TR data, such as issues with new reporting frameworks or additional authorities requesting data. ESMA will also keep working with TRs to remediate any issues in the area of data access by authorities that have been identified in the course of ESMA investigations. In addition, and in line with the findings of ESMA's TR risk assessment, further investigations in the data access area will be performed to specific TRs to ensure that authorities are receiving complete and accurate data according to their mandate and in a timely manner. At the same time, ESMA will keep following-up any relevant incidents notifications or issues reported by NCAs with regard to sufficient and appropriate access by authorities to TR data.

5.3.2 Technology trends and internal control

208. Some TRs have started revising their system architecture in response to deficiencies in their respective operational environment changes and existing or new regulatory requirements. ESMA will closely monitor the relevant re-architecture projects and system changes as regards the corresponding timelines and the resulting outcomes, and will proceed with the agreed upon remediation action plans in case deviations from requirements and commitments are identified.

209. Moreover, ESMA will monitor the actions TRs are taking to ensure timely compliance with new regulatory requirements that will come into force in 2017.

210. Some TRs have expressed an interest to move to cloud computing and respective services while others are considering to move in this direction. ESMA is currently focusing on understanding and assessing cloud computing key risks and controls in the context of compliance with EMIR.

211. In order for ESMA to sustain an effective risk assessment capability and perform its ongoing supervisory activities, high quality data and information at an appropriate level of granularity should be made available by TRs. Therefore, ESMA will look into improving the system and compliance-related periodic reporting requirements.

5.3.3 Strategy and governance

212. As set out in Section 2.1, ESMA has observed that TRs are, apart from further improving their core services offered under EMIR, exploring different possibilities to add value to these services or expand their businesses in new directions.

213. In 2017, ESMA will actively engage with the involved TRs to promptly identify and assess the impact of their strategic directions and to monitor how the entity specific governance allows for appropriate decision making in support of EMIR compliance.

214. In addition, ESMA will continue to take a close look at the relationship between TRs and their parent companies. In particular, ESMA will actively monitor how prioritisation at group level has an impact on resources, IT developments and outsourcing arrangements that affect the TR.

215. In addition, ESMA will focus on management quality, more specifically by looking at the tone-at-the-top and the behaviour of senior management. This will be achieved by maintaining close and regular interaction with a number of key functions and bodies, including the board and senior executives both at supervised entity and parent company level. ESMA will continue to stress the key role that these functions and bodies play in achieving compliance-oriented behaviour at all levels of the organisation. ESMA will take appropriate supervisory action where it sees room for improvement.

5.4 Work programme for Credit Rating Agencies

5.4.1 Quality of credit ratings

216. The main objective of the CRA Regulation is to ensure that credit ratings are independent, objective and of adequate quality. An important area for ESMA in 2017 to further increase the quality of credit ratings is the follow-up of the Validation Guidelines.[21] ESMA expects that its work regarding the validation and review of CRAs' methodologies should help improve the overall quality of the validation performed by CRAs and subsequently the quality of credit rating methodologies and credit ratings, which would result in a benefit to users of ratings. In 2017, ESMA will closely monitor and engage with CRAs on the implementation of the Validation Guidelines. This will be one of the main areas of supervisory attention for ESMA, which is also driven by a high level of methodologies risk identified during the risk assessment.

217. When considering (validation of) methodologies, ESMA looks at all components that a credit rating methodology may consist of, including models, key rating assumptions and

[21] See https://www.esma.europa.eu/press-news/esma-news/esma-finalises-guidelines-validation-and-review-cras%E2%80%99-methodologies

criteria as these are closely interlinked. This means that ESMA will look into the validation of all these aspects of the methodology.

218. The high level of methodology risk mentioned above is also driven by issues that ESMA has identified regarding the models used in the rating process. ESMA will follow-up on such issues where necessary.

219. If ESMA finds outliers or unexpected patterns in credit ratings data, it triggers further supervisory work to understand the root cause. Examples of asset classes where there have been significant rating changes over the last few years are the structured finance and sovereign asset classes. Over the course of 2017, in light of the relatively high level of risk that has been identified in this area, ESMA will closely monitor further developments and follow-up on a number of trends it has observed in the ratings issued by some CRAs. As stated above, the information reported through RADAR will enable ESMA to receive more granular information on credit ratings, which will allow for a more in-depth analysis of rating actions starting from 2017. ESMA will use this data to engage more with the analytical function on the reasons for different patterns or outliers. In addition, ESMA is running investigations in this area which will be finalised in the course of 2017.

5.4.2 IT and internal controls

220. First, ESMA will focus on the highest IT risk areas identified for each of the largest CRAs operating globally. These risk areas were already communicated to the entities in January 2016, in the context of the IT risk assessment and include governance and strategy risks, information security risks, and IT systems development and project management risks. At the same time, ESMA will actively monitor and assess, if required, information regarding cyber-security strategies and frameworks, CRAs' IT strategies and the CRAs' Board and senior management's awareness of IT risks. ESMA will also look into CRAs' preparedness and responses to incidents and the acquisition, development and maintenance of IT systems that support CRAs' rating business. ESMA will base its work in this area on periodic information or additional information it may request, including results of risk assessments, compliance reviews, internal audits and other third-party assessments, information security and IT related incidents.

221. Second, ESMA will engage with CRAs on how they deal with conflicts of interest. Over the past year, ESMA has found a number of instances where (potential) conflicts of interest were not identified, eliminated, or managed and disclosed in accordance with the CRA Regulation. ESMA will follow-up on a number of these issues and take supervisory action where necessary.

222. Further, related to internal control, ESMA will also look into the integrity and independence of the rating process. This is driven by the high level of rating process risk in a number of

CRAs as identified through supervisory follow-up. The purpose of this effort is to assess whether CRAs have taken all necessary steps to ensure that their credit ratings are not affected by any existing or potential conflicts of interest or business relationships.

5.4.3 Strategy and governance

223. In light of the relatively high level of governance risk that ESMA has identified in its risk assessment and the importance of strategy and governance for the conduct of CRAs, the competitive landscape and the quality of ratings, ESMA will focus on the following topics in this area in 2017.

224. As set out in Section 3.1, ESMA has observed over 2016 that competition and to some extent consolidation is having an impact on the CRA industry. In addition, the economic environment and the Brexit are also having an effect on the strategic decisions taken by CRAs and their governance structures. In parallel, some CRAs are undergoing important reorganisations. ESMA will closely follow developments at an industry level through regular interactions with CRAs' senior management and other stakeholders.

225. Besides the work that ESMA will be conducting regarding the Brexit and the project on fees and ancillary services (see Chapter 4), ESMA will closely monitor material changes made by CRAs to their governance structures and assess whether these comply with CRAs' obligations under the CRA Regulation. In these instances, ESMA will also pay attention to the ability of CRAs to establish and maintain an effective internal control structure whilst undergoing organisational changes or setting up new structures.

226. ESMA will focus on management quality, i.e. by looking at the tone-at-the-top and the behaviour of senior management. This will be achieved by maintaining close and regular interaction with a number of key functions and bodies within CRAs, including the board, INEDs, and senior executives. ESMA will continue to stress the key role that these functions and bodies play in achieving compliance-oriented behaviour at all levels of the organisation. Where ESMA sees room for improvement it will take appropriate supervisory action.

5.4.4 Risk assessment and use of data

227. As set out in Chapter 1, ESMA has developed new supervisory tools and instruments over the past few years to allow for more effective supervision. This process will continue in 2017, when ESMA intends to start using a newly-developed risk assessment framework. This new framework will be supported by a number of IT tools, which will enable ESMA to perform a more granular, more consistent and continuous risk assessment.

228. As part of this work, in 2017, ESMA will further intensify its work on credit ratings and fees data quality through discussions with CRAs and will fully embed the data received through

RADAR into its daily supervisory and research activities. ESMA will also work on the integration of the RADAR data into its CEREP system, with a view to providing consolidated statistical data to the market in the course of 2017.

229. Despite the amendments made to the Guidelines on periodic information to be submitted to ESMA by CRAs in 2015 (Guidelines on Periodic Information), ESMA still observes diverging standards in terms of content and format of the information reported by CRAs.[22] In addition, these guidelines are not necessarily well integrated and aligned with the new risk assessment framework that ESMA is putting in place. Therefore, ESMA may at some point during 2017 or 2018 adapt the Guidelines on Periodic Information[23], to reflect these issues.

B. Monitoring of Third-Country Central Counterparties

6 Monitoring of Third-Country Central Counterparties in 2016

6.1 Recognition

230. According to Article 25 of EMIR, central counterparties established in non-European countries (TC-CCPs) may only provide clearing services in the EU if they are recognised by ESMA. In addition, under the Capital Requirements Regulation (CRR), credit institutions and investment firms may only benefit from advantageous capital treatment with respect to cleared derivatives transactions, when the CCP they are facing is recognised by ESMA. This has led 46 TC-CCPs to apply for recognition to ESMA[24] (as of 31 December 2016).

231. One of the conditions to be fulfilled for a TC-CCP to be recognised is the adoption by the European Commission (the Commission) of an implementing act determining that the legal and supervisory arrangements of a third country ensure that CCPs authorised in that third country comply with legally binding requirements which are equivalent to the EMIR requirements, the so-called “equivalence decision”. Another condition that needs to be respected is for ESMA to conclude cooperation arrangements with the relevant third-country authorities.

[22] For further information see, https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-609.pdf

[23] https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-609.pdf

[24] https://www.esma.europa.eu/sites/default/files/library/list_of_applicants_tc-ccps.pdf.

232. Following the adoption by the Commission of equivalence decisions for Australia, Hong Kong, Japan and Singapore in October 2014, ESMA recognised 11 TC-CCPs in April and September 2015. Following the equivalence decisions for Canada, Mexico, the Republic of Korea, South Africa and Switzerland in November 2016, another 7 TC-CCPs were recognised[25]. In March 2016 the Commission issued the equivalence decision for CCPs under the jurisdiction of the U.S. Commodity Futures Trading Commission (CFTC) and ESMA consequently recognised 4 corresponding US CCP. With respect to CCP recognitions in those 10 jurisdictions, ESMA concluded 11 Memoranda of Understanding (MoUs)[26] with 15 different authorities[27].

233. The March 2016 equivalence decision for CCPs under the jurisdiction of the CFTC is the only one adopted with conditions. In particular, it states that the legal and supervisory arrangements of the US shall be considered equivalent to the requirements of Title IV of EMIR where the internal rules and procedures of the derivative clearing organisations under the scope of the equivalence decision (CFTC regulated CCPs) ensures that certain conditions are met in relation to the Margin Period of Risk, Anti-Procyclicality measures and the sizing of prefunded resources (default fund and other resources).

234. In addition, the equivalence decision specifies the conditions under which some derivative agricultural contracts can be exempted from the equivalence conditions. These conditions need to be verified by ESMA before recognising US CCPs and need to be monitored on an on-going basis.

235. Finally, on 16 December 2016 the Commission issued equivalence decisions for Japan Commodities CCPs, Brazil, Dubai International Financial Centre, United Arab Emirates, India and New Zealand for which ESMA will thus finalise the corresponding TC-CCP recognition process in 2017.

6.2 On-going monitoring

236. Whilst ESMA does not have, as such, direct supervision powers over TC-CCPs. ESMA has to monitor TC-CCP activity as contemplated in theESMA Regulation[28] and in the context of EMIR[29] to ensure EU financial stability. In addition, ESMA should assess

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[25] https://www.esma.europa.eu/sites/default/files/library/third-country_ccps_recognised_under_emir.pdf.

[26] https://www.esma.europa.eu/regulation/post-trading/central-counterparties-ccps.

[27] In some jurisdictions more than one authority is responsible for one CCP's supervision and in some federal countries each province/state has its own relevant authority or multiple authorities.

[28] Recital 43 of Regulation (EU) No 1095/2010: "*In order to safeguard financial stability it is necessary to identify, at an early stage, trends, potential risks and vulnerabilities stemming from the micro-prudential level, across borders and across sectors. [ESMA] should monitor and assess such developments in the area of its competence and, where necessary, inform the EP, the Council, the [EC], the other [ESAs] and the ESRB on a regular and, as necessary, on an ad hoc basis*."

[29] See for example recital 19 of the EC implementing act also states that "*The [EC], informed by ESMA, should continue monitoring the evolution of the Japanese legal and supervisory framework for CCPs and the fulfilment of the conditions [laid down in Article 25(6) of EMIR] on the basis of which [the] decision has been taken*."

whether the classes of OTC derivatives cleared by recognised TC-CCPs should be subject to the clearing obligation.

237. Therefore, following the recognition of a TC-CCP, ESMA has the obligation to regularly monitor the range of activities and services that the TC-CCP provides in the EU, so as to be able to identify potential situations in which the recognition of the CCP should be reviewed. In the context of the CFTC regulated CCPs ESMA also has to monitor the conditions set by the Commission in the equivalence decision.

238. For example, instead of adopting one of the EMIR Anti-Procyclicality tools CFTC regulated CCPs can choose to adopt equivalent measures, which one of them did. Therefore, to regularly check that equivalence is guaranteed, ESMA receives quarterly updates on the performance of the relevant CFTC regulated CCP regarding the stability and conservativeness of those measures.

239. To perform those monitoring tasks while promoting financial stability, orderly markets functioning and enhancing investor protection, ESMA has decided to focus on the risks that are more likely to materialise and negatively impact the EU financial stability or orderly markets or cause harm to investors.

240. To this end, for recognised TC-CCPs, ESMA aims at gathering information on interlinkages and exposures of EU entities with the TC-CCP. Leveraging on the CPMI public disclosure framework, ESMA has defined a data request covering six areas:

- The EU products, currencies and trading venues serviced by the CCP;
- The EU clearing members' activity within the CCP on securities and derivatives (exchange traded and OTC);
- The corresponding EU clearing members' exposures (default contribution, margin provision and power of assessment);
- Liquidity resources provided by EU entities to the CCP;
- Interoperability arrangements between the CCP and EU CCPs and
- Qualitative information on important changes at the CCP.

241. Under the relevant MoUs, during the summer 2016, ESMA has requested the assistance of the third-country authorities to obtain the above mentioned information. The MoUs stipulate that requests for information should be made in a manner that is consistent with the goal of minimising administrative burdens. With this objective in mind, ESMA envisages conducting such request for information on a yearly basis, even though it encourages the third-country authorities to inform ESMA of any relevant change in the CCP activity as soon as the former becomes aware of it.

242. ESMA is currently reviewing and checking the data received and is issuing corresponding follow-up requests to finalise its analysis. As part of this process, ESMA intends to refine the output it will produce and to better identify the areas of monitoring focus for the following years.

7 Third-Country Central Counterparties monitoring work programme for 2017

243. The recognition of TC-CCPs is an ongoing task for ESMA. In this context, ESMA will assess that the remaining 21 applicant TC-CCPs, especially in light of the lately issued equivalence decisions referred to in paragraph 235, or any new applicant, meet the criteria for recognition established in EMIR and any additional condition established in the relevant equivalence decisions. ESMA will also review the recognition of the recognised TC-CCPs in case they extend their range of activities or services in the EU.

244. In the context of initial recognitions or of extensions of range of activities and services, ESMA will assess whether the classes of OTC derivatives cleared by recognised TC-CCPs should be subject to the clearing obligation as foreseen in EMIR.

245. ESMA will also continue to co-operate with third-country authorities and analyse the data received to ensure that TC-CCPs comply on an ongoing basis with the EMIR criteria and equivalence conditions and that the services provided to EU entities do not expose the latter to undue risks.

246. In relation to the results of the data request of 2016, ESMA will build indicators to evaluate whether there are potential risks for the EU emerging from TC-CCP activity that are not properly addressed through the current schemes and if so, identify the most efficient way to tackle them.

247. Currently some indicator levels are being defined and will need to be confirmed depending on the type of financial instruments or transactions. The focus is on the level of TC-CCPs clearing activity in EUR and the corresponding share of EU entities and the level of resources provided by EU entities to TC-CCPs.

248. In the context of TC-CCP recognition but also when performing on-going monitoring, ESMA will cooperate with the relevant competent authorities in the EU. When identifying potential situations leading to significant unmitigated risks for a particular EU Member State or currency and when permitted under the MoUs, ESMA will share the relevant information with the relevant authorities. ESMA will also ask any information deemed necessary either to identify potential situations in which the recognition of the CCP should be reviewed or more generally to assess the EU financial stability.

Conclusion

249. This report has highlighted the supervisory activities carried out by ESMA regarding CRAs, TRs and TC-CCPs monitoring activities during 2016. It also sets out some of ESMA's main supervisory priorities for 2017.

250. Regarding the supervision of CRAs, ESMA's key achievements include the imposition of a fine against a CRA for failure to comply with the requirements of the CRA Regulation. ESMA has also successfully concluded a number of investigations into the process of issuing credit ratings, the validation and review of credit rating methodologies, and an assessment of the IT risks faced by some CRAs.

251. Regarding the supervision of TRs, in 2016 ESMA carried out extensive supervisory work to improve the quality of the data, access to data held by TRs, and the operation and performance of TRs' systems. ESMA also initiated a new framework to increase cooperation with NCAs regarding data quality issues, which is expected to be expanded to include additional authorities analysing TR data in 2017. In addition, ESMA imposed its first fine on a TR.

252. ESMA has used a risk-based approach to identify a number of key areas on which it will focus its TR supervisory activities in 2017. These are similar to the areas identified in 2016, including:

- Data quality and access by authorities;
- Technology trends and internal control; and
- Strategy and governance.

253. The main areas identified for CRA supervision include:

- Quality of credit ratings;
- IT and internal controls;
- Strategy and governance; and
- Risk assessment and data.

254. In addition, ESMA has identified that there are a number of areas which raise issues that are common to all supervised entities, such as their approaches to information security and the fees charged to customers for both core and ancillary services. Furthermore, in 2017, ESMA will continue to develop specific tools to increase its internal data centralisation and information processing capabilities. This will enhance ESMA's analytical capacity and promote more detailed and more regular risk assessment and prioritisation.

255. ESMA will make use of all the supervisory tools at its disposal to achieve its objectives, from market monitoring and intelligence gathering to on-site inspections and investigations. ESMA notes that complaints and market intelligence are a valuable source of information and encourages market participants to contact ESMA if they have information that can be useful in our supervision.

256. ESMA will also publish one or more thematic reports to clarify its expectations on issues of interest to all supervised entities in appropriate cases. These thematic reports can be an effective means of disseminating industry data and statistics as well as helping to stimulate the development of a culture of compliance within supervised entities and outline supervisory expectations.

257. In 2017, ESMA will seek to build on its international work so that it can benefit from the experience of its fellow supervisors and will enter into cooperation agreements and Memoranda of Understanding to promote information sharing and joint investigatory work where possible.

258. Regarding TC-CCPs recognition and monitoring, in 2017, ESMA will pursue the recognition of the remaining (and new) TC-CCP applicants and will concentrate on defining indicators to detect any unmitigated risks for the EU financial stability coming from recognised TC-CCP activity and, when necessary, find the most efficient remediation in cooperation with the relevant EU and non-EU authorities.