

# Building safe digital financial markets: a collective effort

ISLA 30th Annual Securities Finance & Collateral Management Conference, 21 June 2023, Lisbon

## Verena Ross

ESMA Chair

Ladies and Gentlemen, Good morning.

I would like first to thank ISLA for this invitation and for giving me the opportunity to address this audience. Happy 30<sup>th</sup> birthday!

The first time an ESMA Chair, my predecessor Mr Steven Maijor, gave a keynote at an ISLA conference was in 2013. Already a decade ago. A very busy and eventful decade, I would say.

Back in 2013, ESMA was still a recently founded authority created in the aftermath of the financial crisis with the objectives of enhancing investor protection, promoting orderly financial markets and safeguarding financial stability. Although this overarching mission has not changed, our perimeter of action, our responsibilities and the associated powers have evolved over time. This is not surprising given securities markets and financial risks have become more multifaceted. ESMA's remit now includes more direct supervisory tasks as well as new fields of expertise, such as crypto-assets and sustainable finance.

When ESMA was created, back in 2011, it was in reaction to an event which was intrinsic to the financial markets. But the past few years have shown that crises in financial markets can also be triggered by factors that are exogenous to financial markets, including geopolitical events. The financial world is more complex today and so is the task of financial regulators and supervisors worldwide.

Let me start with a couple of words about current market conditions. As emphasised in our latest trends, risks and vulnerabilities report, we note continued uncertainty in the markets. Risks arise from high inflation, global tightening of financial conditions, and the geopolitical environment. The report also noted the materialisation of peripheral risks, continued issues around leverage, liquidity and interconnectivity, together with growing concerns over business

practices in the crypto space or cyber risk. Although economic sentiment has become somewhat more positive in early 2023, there is certainly no room for complacency and ESMA is keeping the overall risk assessment across its remit at the highest level. The current testing wider market conditions confirm the need for continued efforts in building a resilient European financial system, capable of providing the capital our economies need to fund their growth, to withstand sudden economic shocks and to provide a trusted environment for retail investors.

I just mentioned growing concerns over business practices regarding crypto-assets and I would like to develop this further. Technological innovation is changing the way financial products are being designed, distributed and consumed - facilitating retail participation in financial markets but also creating new risks for them. ESMA has always taken these new risks related to crypto-assets very seriously and has been proactive in alerting consumers about extreme price volatility, speculation, governance issues and fraud associated with these often unregulated products and activities. ESMA has been issuing regular public warnings over the years, beginning in 2018.

At the same time, we acknowledge that the development of the Distributed Ledger Technology (DLT) and its various financial applications can open opportunities for the EU financial sector. DLT infrastructures and tokenisation may facilitate the improvement of back-end processes by reducing reliance on manual tasks (through greater automation), optimising asset use, and ensuring more efficient settlement processes, among other use cases. Of course, the large-scale adoption of the technology remains to be seen, as well as how the potential associated risks can be mitigated.

These are just a couple of examples in how new technologies and innovations are reshaping the financial services market. In this context, I believe that finalisation of the Digital Finance Package represents a very positive step in terms of creating an adequate regulatory and supervisory framework in the EU for the use of these new technologies.

## **MiCA**

As you know, the Markets in Crypto-Assets regulation, or MiCA, was recently published in the Official Journal of European Union, concluding 2.5 years of intense legislative debate and negotiations. This is surely a very important milestone which demonstrates the ability of the European Union to respond proactively to an evolving financial landscape and to set high-level regulatory standards. This approach now seems to be increasingly being looked at also as a possible model by other regulators around the globe.

Although the publication of MiCA is an important milestone, it is for ESMA only the beginning of the journey. The publication officially launches the implementing phase of MiCA, during which ESMA and EBA will have pivotal roles to play.

MiCA includes more than 50 mandates for developing level 2 and level 3 measures. For ESMA alone, this represents more than 30 mandates to be developed within the next 12-to-18

months. These mandates cover a very broad scope of topics, including the authorisation of crypto-asset services providers (CASPs), the governance of these CASPs, their conduct of business, their operational resilience, disclosure requirements and ultimately the supervision of future authorised entities.

In order to make the task more digestible for all concerned parties, including market participants, ESMA has established a phased consultation plan which foresees the sequential publication of three consultation packages: one early July, one in October and a third one early next year.

This will certainly be an interesting journey for all of us.

The crypto-asset community is of course diverse with both new and traditional players active in these markets. But it remains a nascent industry dominated by newer entities (often based outside of the EU) who have little to no experience navigating the European policymaking process.

I make this point here to stress the important role that more traditional players should play in terms of providing knowledge, expertise and guidance in helping an orderly technological transition for financial markets. Creating a safe and inclusive financial marketplace is not the sole prerogative of regulators — it should be regarded as a collective effort. With this principle in mind, we welcome industry-led initiatives to facilitate the efficient and prudent adoption of new technologies through, for example, the development of harmonised standards and the promotion of coordinated practices within the industry. The ISLA efforts in this respect are very much welcome.

At the ESMA level, we are also approaching the implementation of MiCA not only through the development of legal obligations and implementing measures but also through the lens of cooperation. Although a lot of work will have to go in the coming months to the development of the Level 2 and Level 3 measures, ensuring a smooth transition to MiCA will also require significant coordination activity between supervisory authorities. We are therefore also prioritising initiatives at ESMA level to promote convergent approaches to authorisation and supervision of crypto-asset service providers, by sharing experiences, learning lessons from each other and finding common approaches wherever possible.

MiCA will apply to activities that were previously largely unregulated and it is therefore necessary to anticipate initiatives promoting the establishment of convergent supervisory practices at national level to ensure a level playing field across the EU single market.

### **DLT Pilot**

Distributed Ledger Technology offers a very diverse range of use cases which are not all within the scope of MiCA but can also be applied to more traditional sectors. Applied to financial instruments, it can make settlement cycles quicker, more efficient, and more transparent

because it requires fewer intermediaries and enables greater automation. To capitalise on these benefits, financial entities interested in testing the new technology may apply for the DLT Pilot Regime, which entered into application in the EU in March of this year. The DLT Pilot Regime provides the legal framework for trading and settlement of transactions in crypto-assets that qualify as financial instruments under MiFID II.

The DLT Pilot Regime facilitates the set-up of new types of market infrastructures, such as a DLT multilateral trading facility, a DLT settlement system, as well as a combined DLT trading and settlement system. In addition to established investment firms, market operators or CSDs, new entrants may also apply for the DLT Pilot Regime.

Under the DLT Pilot Regime, National Competent Authorities (NCAs) will authorise and supervise firms, while ESMA will have an important coordination and convergence role. For example, ESMA has issued and will continue to issue guidance on several aspects of the DLT Pilot Regime and will be able to give opinions on the national authorisations.

We are glad to see that the first two official applications have already been submitted and around 15 other potential applications are in the pipeline for the second half of this year and the beginning of next year. This confirms the interest in the technology and the relevance of the regulatory sandbox approach adopted.

The DLT Pilot Regime is supposed to run for a period of three years initially, with the possibility to be extended for another three years by the European Commission, based on a report to be provided by ESMA.

One of the key elements of the DLT Pilot Regime is that it will allow disintermediation and direct access for retail investors to trading and settlement platforms--a possibility which was not foreseen in MiFID II or CSDR. As already mentioned, the DLT Pilot Regime will also allow for the creation of a new and more integrated type of Financial Market Infrastructure (FMI) merging trading and settlement (DLT trading and settlement system).

In the absence of central bank digital currencies, a significant challenge but also an opportunity provided by the DLT Pilot Regime is the possibility to use innovative solutions for cash settlement that do not involve traditional cash. For example, DLTs can accommodate the use, for settlement purposes, of so-called "settlement coins" which can take the form of tokenised versions of commercial bank money or e-money tokens (as defined in MiCA).

The practical applications being developed in these areas should provide valuable lessons for the future. It will help all of us to understand the value added in the use of DLT and whether the technology can deliver on its promises of increased efficiencies, lower transaction costs, and increased accessibility for retail investors, while adequately mitigating the related risks.

I think it is important to show that there are viable and successful use cases in the EU, without compromising on the safety and resilience of market infrastructures and market participants'

systems. It is equally important to create a trustworthy environment that prioritises investor protection and orderly markets in tokenised financial assets.

ESMA stands ready to support this learning experience and development process in a collaborative and inclusive way by working closely with both NCAs and market participants that are willing to take part in the DLT Pilot. In the medium-to-long term, the lessons learned may result in changes to the main sectoral legislation in the EU, such as MiFID II and CSDR.

## **CSDR**

Let me now turn to CSDR, the EU Regulation that provides the main legal framework for securities settlement services and CSD activities in the EU. In application since 2014, CSDR recognises the systemic importance of CSDs by introducing a single set of EU rules, with a view to increase the resilience of European CSDs and facilitate cross-border settlement. CSDR has also harmonised certain aspects of the settlement cycle and of settlement discipline.

Next year we intend to publish a report on settlement efficiency in the EU, including the impact of cash penalties and a comparison between CSD settlement and settlement internalised at the level of custodians. In preparation for this report, ESMA is in contact with trade associations, including ISLA.

We believe that an important part of the work to improve settlement efficiency is to identify and address the root causes of settlement fails, by looking at the entire custody and settlement chain. This is going to take a joint effort, involving CSDs and market participants in general.

Another topic which may impact settlement efficiency is a reduced settlement cycle. I am sure you are all well aware of the lively discussions around the potential move to T+1 in the EU, given the planned move in the US in May next year. In fact, I have noticed you also have a dedicated session on this topic at this conference.

According to the ongoing negotiations on the CSDR Review, ESMA may get a mandate to elaborate a report covering: (i) an overview of international developments on settlement cycles and their impact on capital markets in the Union; (ii) an assessment of the costs and benefits of shortening the settlement cycle in the Union, differentiating where appropriate between types of financial instruments; and (iii) a detailed assessment and timeline of how to move to a shorter settlement cycle, differentiating, where appropriate, between different financial instruments.

ESMA has started first discussions with NCAs as well as with the industry, which have highlighted the importance to continue monitoring international developments on T+1 and understanding the impact on EU market players. There is also heightened interest in investigating the potential for shortening of the securities settlement cycle in the EU. At the same time, there seems to be a common view that settlement efficiency remains the priority in the EU for now. We are closely following the EU cross-industry workstreams on this topic.

We plan to keep the dialogue open with the industry, including ISLA, on this important topic, and we may launch a call for evidence to gather data, once the ESMA mandate in the CSDR Refit is confirmed.

Coming now to the end of my intervention, I would like to conclude by emphasising how important the ongoing cooperation and communication with market participants and trade associations, such as ISLA, is in our joint efforts to face the challenges and opportunities that new technology provides for the European capital markets. ESMA's primary focus will remain on enhancing investor protection, promoting orderly financial markets in the EU and contributing to financial stability. However, as ESMA we have also made a commitment to focus our activities over the next years on the cross-cutting trends of enabling sustainable finance and facilitating technological innovation (as well as effective use of data).

Effectively implementing the various initiatives of the EU's Digital Finance agenda is part of that commitment – whether that is in the context of MiCA, DORA (which I did not speak about today) or the DLT pilot regime. We need to – collectively – get this right, to ensure we can harvest the opportunities new digital technologies provide for the European capital markets, while ensuring stable and orderly markets and the protection of investors.

Thank you for your attention and I hope you will enjoy the rest of the conference and take many new insights away with you.