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How the new regulatory and supervisory framework protects Europe's markets and consumers

Stakeholder Conference – Central Bank of Ireland

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Ladies and Gentlemen,

I am pleased to have the opportunity to speak to you today, on what is my first visit to Ireland in my capacity as Chair of the European Securities and Markets Authority. I would like to thank the Central Bank of Ireland for its invitation, and compliment it on bringing together such distinguished speakers and panellists. I am very glad to have the opportunity to cover a topic today which continues to be at the core of regulators work – strengthening markets and improving consumer protection.

While I do not intend to dwell on the causes of the current financial crisis, and most of you here today do not need to be reminded of its impact on Ireland, I would beg your indulgence in allowing me to say a few words about what I believe to be one of its more positive outcomes, namely the establishment of the European System of Financial Supervision and the creation of the European Supervisory Authorities for securities, banking and insurance in 2011. This was a crucial political decision on the part of the European Union (EU) to improve financial services regulation and supervision in Europe.

ESMA, which I have the honour to chair, was one of these new institutions given the mission of improving the protection of investors and promoting stable and well-functioning financial markets in the EU. The last 12 months have been a busy time for my staff, on the organisational, regulatory and supervisory fronts, as we have set about building an organisation fit for purpose and forged ahead in meeting our objectives.

In terms of operational set-up, ESMA began life with about 40 staff from its predecessor body, the Committee of European Securities Regulators, at the beginning of 2011 but by year's end had nearly doubled to about 75. This included the recruitment of a middle management tier to ensure that we had the resources in place to support delivery on our responsibilities. We have succeeded in recruiting highly qualified candidates from varied backgrounds including government, regulatory bodies and the private sector. And we are not finished yet, by the end of this year we intend to have 100 staff on board and I would like to take this opportunity to say that we are still keen on attracting experienced candidates from as broad a range of backgrounds as possible.

ESMA's Role

I would now like to move on to speak about our role and work programme. ESMA has two key objectives as an organisation, contributing to its overall mission, which are the building of a single rulebook for the regulation of the EU's financial markets and ensuring its consistent application by establishing a consistent supervisory framework. While these are ambitious objectives, presenting significant challenges, I feel that ESMA has already demonstrated

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substantial progress over its first 15 months, particularly when seen against the background of a further deterioration in Europe's financial markets and the continuation of the regulatory change agenda. It was against this background that we assumed our role in EU markets supervision, either through direct supervision, such as with credit rating agencies (CRAs) or the co-ordination of actions or exchange of information by national competent authorities, especially regarding short-selling, financial reporting, market microstructures and clearing and settlement.

Before I move on to discuss more extensively our work on the single rule book, supervisory convergence and supervision, I should underline that ESMA together with the national authorities form a network organization. While ESMA has many new tasks and powers, the new framework can only be effective when it is based on extensive cooperation with national supervisory authorities. In this context I would like to mention the very active participation by the Central Bank of Ireland in ESMA's activities, and more specifically ESMA's Board of Supervisors.

Development of a Single Rulebook

As well as its co-ordination role ESMA took on its new role as EU securities markets standard setter with responsibilities regarding the development of technical standards and advice for new, or soon to be revised, pieces of legislation. These dealt with markets (MiFID), their infrastructure (EMIR), transparency (TD, PD, IFRS) and orderly functioning (short-selling, MAD), along with rules for financial market participants such as CRAs and investment funds (UCITS, AIFMD). It feels at times like being the regulator for acronyms.

One priority area where ESMA has been active, and which has also recently made headlines, has been in relation to the Alternative Investment Fund Managers Directive - AIFMD. In November 2011 we delivered to the Commission our advice on the implementation of aspects of the Directive. This was a top priority for 2011 and I believe we provided a high-quality submission, covering a broad range of subjects, which had benefitted from constructive submissions from a wide variety of stakeholders.

However, we have recently seen attempts, based on an unpublished draft of the Commission's final text, to portray ESMA and the Commission as being at loggerheads over the treatment of our advice in the final text which will be presented to the European Parliament and Council. I would like to take this opportunity to reiterate that, while the Commission has requested ESMA's technical advice on this topic, the Commission has final responsibility for how the Directive is interpreted and is under no obligation to accept any of our advice, never mind all of it. The fact of the matter is that the vast majority of ESMA's advice has been accepted by the Commission without amendment, and those divergences that do exist are a matter for the Commission. However, we believe that ESMA's overall approach, resulting from broad consensus amongst the 27 EU national supervisors and the input of many stakeholders, remains the best option. My final word on the issue is that the final text is not due to be published until July so there may still be changes, however this is no longer in ESMA's hands but firmly in those of the executive and legislature. Later in my speech I will come back to the AIFMD when discussing ESMA's international activities.

Another area where we have been active with EU wide rules concerns trading in a highly automated environment, which is more popularly known as HFT. A developing concern in EU and global markets has been the perceived impact of the growth in HFT. ESMA consulted on this issue in the summer of 2011 and published its final report, this February, containing guidelines that have the two-fold aim of increasing the robustness of markets, by maintaining their orderly functioning, and ensuring common, uniform and consistent application of MiFID and the Market Abuse Directive (MAD) across the EU for the specific case of HFT. However, our guidelines will not be our final contribution to HFT. I am sure that the revision of MIFID will result in further steps in the area of HFT, on a stronger legislative footing.

On the single rule book I should finally mention that we have just finalised the draft technical standards for the EU-wide short selling regulation. Also, based on the EMIR Regulation, we will consult before the summer on draft technical standards for the EU for mandatory central clearing of derivatives and for market infrastructures such as CCPs and Trade Repositories.

Supervisory Convergence

Part of ESMA's raison d'être is to foster supervisory convergence thereby reducing the risk of regulatory arbitrage which has the potential to undermine not only the integrity, efficiency and orderly functioning of markets but ultimately financial stability. While the single rulebook will contribute to this convergence, and is still very much a work in progress, ESMA has been active in a number of areas which should create the environment in which this common approach can take root. I would now like to touch on a number of ESMA activities that have contributed to this supervisory convergence.

The most high profile action taken to date was our co-ordination, last August, of simultaneous bans on net short positions in Belgium, France, Italy and Spain. Throughout the period of the bans, ESMA played an active co-ordination role in the adoption of the emergency measures, aligning the interpretation and implementation of the measures and assessing whether to lift or maintain them. The ability to take emergency measures regarding short selling remains with national authorities for the moment. However, ESMA has demonstrated by its coordination of these measures that it has the necessary expertise to soon take on the powers to take action on short-selling that it has been granted under the new short-selling regime.

The financial crisis has had a major impact on the financial performance of publicly traded companies, particularly in the financial sector. As a result of the sovereign debt crisis ESMA focused its attention on its impact on the accounting practices of listed companies in Europe, specifically financial institutions, with respect to their sovereign debt exposures. Last July, we issued a statement stressing the need for enhanced transparency and the application of the relevant IFRS, and ESMA also encouraged issuers to disclose their stressed sovereign debt exposures on a country-by-country basis in their financial statements. Following that, we assessed the accounting treatment of Greek sovereign debt in the half-year financial statements of EU-listed financial institutions and, to promote consistent application in the year-end statements, published advice in November on its treatment. We also issued an Opinion on Accounting for Exposure to Greek Sovereign Debt.

In the area of markets, ESMA contributed to building a common supervisory culture and consistent supervisory practices with the publication of a revised version of its waiver document. This document summarises our positions on proposed waivers from pre-trade transparency obligations for regulated markets and MTFs under MiFID. These pre-trade transparency waivers are very sensitive to regulatory competition across European markets, and we therefore need to be sure that we are consistent. As a result of the assessment of all current waivers, we found that some of them were not consistent with MIFID, including some waivers that are currently used by market participants. I am sure that these practices will soon end and that we will achieve a level playing field.

On supervisory convergence I should finally mention the report that we published yesterday on the use of sanctions across the EU to combat market abuse. To be brief, I should say that there is a wide variation in sanctions regarding market abuse cases. Some of this variation needs to be tackled by the new upcoming EU legislation (MAD and MAR), but there is also a task for securities markets enforcers to use their sanction tool box to the fullest extent possible and to allocate sufficient resources to market abuse enforcement.

Supervision

ESMA is the only ESA currently exercising direct supervisory responsibilities of market participants, having taken on in July 2011 the responsibility for the registration and supervision of CRAs wishing to conduct business in the EU. Bringing CRAs under the umbrella of EU supervision is a milestone achievement which will contribute to a sounder rating process and thus more resilient markets and improved investor protection. We have also undertaken our first on-site inspections in December 2011, which will become a regular feature of our oversight of this market sector, and published the findings in March.

ESMA's role in international cooperation

On international cooperation ESMA will play a central role in Europe and we will foster consistent application of European rules toward third country entities. ESMA will also ensure that Europe speaks with one single voice when we have to deal with third county regulators and will strengthen Europe's position.

Let me first comment on our general philosophy regarding international cooperation. I believe that the easiest and most efficient option is relying on the so-called mutual recognition model. Without mutual recognition, entities operating on a cross-border basis would be subject to different requirements and to the jurisdiction of different authorities. This exposes them to potentially conflicting requirements and to higher compliance costs. Global leaders have established common objectives at G20 levels and regulators have set up a number of international groups aiming at international consistency of the different regimes. At the end of the process we will need to rely on equivalence and co-operation among authorities. We will never be effective if a single regulator seeks to regulate global financial markets from one single location.

One of the areas where we have applied this model concerns the endorsement assessment of 3rd countries for CRAs and this has been one of the international areas receiving a lot of attention from ESMA. The essence of the assessment is whether ratings from 3rd countries used in the EU meet EU requirements. While the banking industry in particular was understandably concerned about sufficient 3rd countries being endorsed before the 30 April deadline, we can now see that the most important 3rd countries have been endorsed. Looking back at the whole assessment process, I am quite positive about the current 3rd country regime for CRAs. It ensures a level playing field between the EU and other regions, and investors can expect the same quality of endorsed non-EU ratings as EU-ratings. Therefore, I see no reason to reopen the debate on the current 3rd country regime of CRAs. Equally, we should be very careful that we do not introduce new uncertainty with the 3rd country regime under the new CRA proposals. While I fully support taking some further steps regarding the regulation and supervision of CRAs, it is not realistic to assume that the rest of the world will quickly follow our moves. Hence, asking 3rd country ratings to be subject to these new EU requirements will certainly result in endorsement problems and unnecessary uncertainty for EU financial markets.

Let me conclude on our international activities by returning to the AIFMD topic. One of its most complex features is the 3rd country framework for non-EU entities. ESMA will play a central co-ordinating role in negotiating Memoranda of Understanding on behalf of EU supervisors with non-EU supervisors thereby ensuring a consistent application of EU rules toward third country entities. This centralised approach has a number of advantages: it allows non-EU authorities to deal with a single interlocutor rather than dealing with 27 different authorities; it reduces the burden on EU authorities and it will help create a level playing field vis-à-vis third country entities as ESMA.

Investor Protection

Investor protection is a core ESMA objective. It is ingrained in its establishing Regulation and informs many of our actions. There is a history in European securities markets of developing common approaches to the equal treatment and protection of investors. This has generally been done by setting standards for the harmonisation of conduct of business rules across the European Union's Member States. As a result of lessons learned from the early experiences of this financial crisis, for example, CESR was vested with the responsibility of helping to ensure, and improve, the consistent implementation and application of the MiFID investor protection provisions. As you will be aware, the Markets in Financial Instruments Directive (MiFID) was introduced in 2007 in order to harmonise the investor protection framework across the European Union, and is one of the most important milestones in this area.

However, with the creation of ESMA and the other two European Supervisory Authorities (ESAs), this work has the potential to be greatly enhanced. All three ESAs have been tasked with an explicit investor protection responsibility. As you well know, the Regulation establishing ESMA specifically states that, as one of its tasks, ESMA "shall foster investor protection". It further describes certain ESMA "tasks related to consumer protection and financial activities".

Ingraining investor protection responsibility into the EU regulatory framework in this way is a significant step forward, it moves investor protection onto another plane. What is significant about our new powers, and this explicit responsibility, is that we can now change the way we do things. In particular, we can take a much more pro-active, and effective, approach towards investor protection. I will describe what I mean by this shortly, but first let me make some comments on financial innovation and competition.

Financial innovation and competition

The financial crisis of 2008 and the subsequent sovereign debt crisis have clearly demonstrated that innovation in financial markets is a double-edged sword. The "de-structuring of the lending value chain" combined with ever more sophisticated securitisation solutions has generated none of the expected or supposed benefits. Consumers increased access to credit was short lived and the spreading of counterparty risks failed to materialise. On the contrary, it led to the build-up and explosion of systemic risks as seldom seen before. Similarly, complex lending schemes combined with creative accounting has led to very unpleasant surprises for some holders of sovereign debt.

But we should not reject innovation as such. As in most other industries, innovation in finance is needed. The emergence of some derivatives products like FX or interest rate products for instance has allowed corporates to have better hedging of the financial risks generated by their commercial operations. But financial innovation needs to respect some core rules in order to benefit the global economy. Let me go through them quickly.

First, the objective of financial innovation should be to better satisfy customers needs. To elaborate on Paul Volcker's famous statement, financial institutions need to be able to come up with many more inventions as useful for consumers as the "cash machine".

Second, financial innovation should not only be a pretext for charging customers more fees. In this respect, the high correlation between sophistication and opacity is a real issue that needs to be addressed. It is justified that firms that innovate are able to obtain a return on their innovation, especially in a world like finance where copyrights do not exist. But this should by no means be done at the expense of consumers or stability of the overall system and economy.

Third, financial innovation needs to be mastered by its promoters. There is no point creating a product, extracting benefit from it, but not being able to keep it under control. Too often financial institutions have not followed the right processes to ensure proper management of innovations. Not only have the benefits for customers been overestimated and the downside underestimated, but the abilities of the relevant institution to appropriately manage the risks associated with the innovation, or even ensure a simple after sale service to consumers, have been left aside.

Fourth, financial innovation needs to be controlled by regulators. Without going as far as the pharmaceutical industry where products have to go through a complex authorisation process, regulators need to get a much tighter grip of financial innovation and the way it is used internally and towards consumers. In order to do that, regulators need to have the financial and legal means to do so. Financial implies the resources to build relevant and independent expertise to analyse complex products. Legal refers to the ability to act. I believe the revision of MiFID will play a key role in this field.

Let me now also say a quick word about the relation between regulation and competition. In the drive for more investor protection, regulators need to be careful about the potential impact of regulation on the structure of industry. The principle of proportionality which is so core in European legislation needs to be respected in order not to favour larger stakeholders or one form of distribution over the other one. In this regard, MiFID II contains several areas where vigilance will be needed. For instance, in the debate on the banning of inducements for independent advice we need to bear in mind the potential impact on the level playing field between smaller players and large integrated distributors.

But financial innovation is not the only issue that investors are faced with. Supervisory experience and market research demonstrate that financial consumers can be confronted with many additional problems.

- **Lack of quality of financial advice.** Unsuitable investment advice is provided, for example, because the extent and the nature of information gathered about a client's profile – on financial needs and background - varies between intermediaries. Limitations in gathering this essential client information, and, importantly, analysing it in order to get an understanding about the client, is a cause for concern.

- **Unsuitable products**. One driver for this is exposure to the high investment risks inherent in some products, for example, coupled with the inherent complexity, opacity or insufficient information of some products. This can be compounded by a lack of compliance with selling practices requirements when selling complex products.

- **Inducements**. Other important factors leading to unsuitable products being recommended are: (i) the conflicts of interest arising due to inducements provided to advisers; and (ii) biases such as the limited range of products from which an adviser can select for recommendation.

These problems cannot be solved with more transparency. This holds true even when the information is “fair, clear and not misleading”. We know now that too much information can confuse clients, especially unsophisticated retail clients, and can lead to them making poor choices or wrong decisions. I must admit here that I am trained as an economist and have always been taught that the combination of rational decision making by consumers, full transparency, and competition among suppliers solves many problems in markets. However, experience has shown that this market mechanism does not work effectively in financial markets and that regulation and supervision is needed to get the right outcomes and to protect financial consumers. In this respect, I fully support the proposal to ban inducements in certain situations as included in the proposal by the EC for MiFID II. Disclosure of inducements is simply not sufficient. At a minimum, we need to ban inducements in the case of discretionary portfolio management and when an advisor wants to have the label “independent”.

Other ESMA investor protection activities

We are currently finalising guidelines to clarify certain aspects of the MiFID suitability and compliance function requirements in order to improve, amongst other things, due diligence on gathering information on the client’s background when providing suitable investment advice. We are also seeking to develop a complimentary set of guidelines on remuneration practices. These will be more focused on remuneration practices of investment firms from an investor protection point of view – relating, as they do, to the MiFID conduct of business risks and conflicts of interest rules when providing investment services.

In December 2011, ESMA took pro-active action by publishing our first investor protection warning. ESMA warned retail investors against dealing with unauthorised firms and individuals offering foreign exchange investments, and alerted retail investors to the main risks involved in forex trading. We will not stop here: working with the national competent authorities, ESMA is alive to issuing further investor warnings as and when the need arises.

I have just mentioned “working with the national competent authorities”. ESMA’s new duties also include the requirement to establish a “Committee on financial innovation”. ESMA’s Financial Innovation Standing Committee (FISC), through the participation of the national competent authorities, aims to assist ESMA in fulfilling its investor protection responsibilities. Through regular data collection on consumer trends, FISC will seek to identify potential risks to investor protection, and to financial stability, in the financial innovation area; and then to produce a risk mitigation strategy.

In this regard, the powers set out in the MiFID proposals for both ESMA and national regulators to intervene to protect investors from inappropriate products or services by banning products is a major leap forward. The key challenge for ESMA here is, of course, the co-ordination of any action taken by national competent authorities. ESMA will need to take account of the fact that some national initiatives may be appropriate to address specific national risks - but other market failures will raise common concerns across the EU. This means that ESMA will have to co-ordinate accordingly – as we should avoid national action creating fragmentation in the market and possibly creating consumer confusion.

Another issue here is the extent and practicability of these intervention powers. Whilst we appreciate the need for building in safeguards and limiting the scope for intervention, we also need to ensure that there is the real possibility for ESMA to take swift action, where necessary, in this important area of product intervention. Looking at the EC proposal, MiFID II should also represent a major step forward by allowing national regulators and ESMA, to have much greater and significant leeway to intervene in the market to ban products or services. As previously mentioned, this is needed to control financial innovation.

ESMA is also active on the investor information and product transparency front. ESMA is currently working to tighten a number of the requirements that apply to Exchange Traded Funds (ETFs) that fall under the UCITS Directive through the development of guidelines. While ETFs can offer certain benefits like low costs of diversification of investor investments, there are certain risks that need to be addressed. Therefore, some of ESMA's key proposals include an obligation on ETFs to include an identifier in their name, additional requirements on disclosure and a general strengthening of the standards on collateral received in the context of securities lending activities.

It is also important to improve consistency across products. While ESMA's work to strengthen the regulatory framework for ETFs is important, it's equally important to bear in mind that many other exchange-traded products (ETPs) compete with ETFs. These other products, such as notes and certificates, may not offer the same regulatory protections as are afforded under the UCITS framework. The Packaged Retail Investment Products (PRIPs) initiative, including the proposed inclusion within MiFID's scope of structured deposits, represents a real step forward with respect to improved disclosures and consistent selling practices for competing products. ESMA fully supports this initiative, especially where it delivers consistent investor protection regardless of the legal form of products. However, we think there is a case for addressing also the manufacture and management of such products.

Concluding remarks

I have talked about the protection of markets and consumers and the new regulatory and supervisory framework. While I have so far treated markets and consumers as two somewhat different areas, let me now conclude with a brief remark on the strong links between them. We are all very much aware of the effects of markets on consumers, and in a time of financial crisis that needs no further discussion. However, it is also important to underline the effects in the other direction. As the IMF convincingly argues in this month's World Economic Outlook, high household debt amplifies downturns and weakens recoveries. While the most important element in households' financial planning relates to mortgages and private real estate, financial products can also be an important part of the financial planning of households. Existing regulation already requires that financial products in the securities area are transparent and should only be advised when they are suitable. However, this is not sufficient to achieve healthy financial households. Firstly, current practices across the EU do not yet meet the regulatory standard. This is clearly primarily a task for the industry, but also for securities markets enforcers, to ensure that selling and advisory practices move into line with the regulatory requirements. Secondly, the current regulatory requirements vary for banking products, insurance products and securities products. To achieve proper financial planning for households, it is important that there is the same level of consumer protection for all types of financial products and that when they are advised and sold, the interactions between the three categories of products are taken into account.

There are currently various legislative proposals underway which will improve financial consumer protection (PRIPS, MIFID II and MIFIR). When further shaping these proposals we need to ensure that they result in effective regulation and supervision covering the complete range of financial products to ensure the ultimate goal of healthy financial households.

To conclude, well-functioning and stable financial markets go hand in hand with healthy financial households. The valuable consolation prize of this financial crisis is that it has provided the momentum and opportunity to make the necessary institutional changes needed for stronger markets and investor protection. ESMA, as a supervisor of both markets and the protection of financial consumers, will do its utmost to ensure that we achieve our goals in both areas.