

SMSG Annual Activity Report 2011-2012



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Foreword by the Chair and vice-Chairs

The Securities and Markets Stakeholder Group (here called the SMSG or the Group) was established in April 2011 under ESMA's founding Regulation to help facilitate consultation with stakeholders in all areas relevant to ESMA's tasks.

It held its first meeting in July 2011 and elected its Chair and Vice-Chairs in October 2011. During 2011 and 2012, the Group held a number of plenary meetings in the presence of the Chair of ESMA, Mr Steven Maijoor and ESMA's Executive Director, Verena Ross. ESMA's staff provided helpful input on a number of the technical issues which have been discussed by the Group. In addition, the Group established a constructive dialogue with the ESMA Board of Supervisors in the context of two joint meetings. The minutes of the meetings of the SMSG are all available on ESMA's website.

This Annual Report summarizes the key achievements of the Group to date.

The SMSG started its work by establishing rules of procedure designed to support the Group's delivery of consensus advice, preferably at the earliest possible phase of ESMA's deliberations.

Since its launch, the Group has produced 14 public opinions, advice and reports. The Group has also delivered a number of informal feedback documents to ESMA. More detail about these activities is provided below. The Group's ambition is to deliver advice at the earliest upstream stage possible and to focus on strategic issues. This means that the SMSG has tried to get involved at an early stage, often by responding to "discussion papers" rather than by taking part in ESMA's later Public Consultations on standards or guidelines. In this context, the Group welcomes the fact that ESMA is developing and formalizing its feedback on Group advice.

In addition to its advice to ESMA, the Group also started working on a number of own initiatives outside of ESMA's Annual Work Programme. In this context, it set up specialized working groups which examine the impact of regulation on the access of SMEs to capital markets, on Investor Protection and on Credit Rating Agencies.

With respect to horizontal issues, the Chair and vice Chairs of the SMSG initiated contacts and discussions with the Chairs of the (EBA) Banking, as well as the EIOPA (Insurance and Occupational Pensions) Stakeholder Groups. The aim is to ensure consistency of advice on key regulatory initiatives by the three European Supervisory Authorities (ESAs), including with respect to investor protection and SME financing in particular.

Regarding ESMA's institutional role, the SMSG furthermore decided to write to the European Commission, Parliament and Council requesting that deadlines set by EU 'level 1' legislation provide adequate time for the submission by ESMA of its technical standards to the Commission.

By 2 January 2014, the Commission must publish a general report on the experience acquired as a result of the operation of the ESAs and the procedures laid down in the ESA Regulations. The SMSG sees this first annual activity report, and its continuing efforts to implement in the most effective way the responsibili-

ties assigned to it as important contributions to this review process, and as assisting in the further improvement of the regulation and supervision of European financial services.

Paris on 18 December 2012



Guillaume Prache
Chair



Judith Hardt
Vice-Chair



Peter De Proft
Vice-Chair



1. SMSG's role and objectives

The Securities and Markets Stakeholder Group (here called the SMSG or the Group) was established under ESMA's founding Regulation to help facilitate consultation with stakeholders in areas relevant to ESMA's tasks. Under the Regulation 1095/2010 establishing ESMA (the ESMA Regulation) there is a requirement to consult the Group on draft guidelines and technical standards issued by ESMA. The role and task of the Securities and Markets Stakeholder Group is spelled out in Article 37 of the ESMA Regulation as follows:

Article 37

Securities and Markets Stakeholder Group

1. To help facilitate consultation with stakeholders in areas relevant to the tasks of the Authority, a Securities and Markets Stakeholder Group shall be established. The Securities and Markets Stakeholder Group shall be consulted on actions taken in accordance with Articles 10 to 15 concerning regulatory technical standards and implementing technical standards and, to the extent that these do not concern individual financial market participants, Article 16 concerning guidelines and recommendations. If actions must be taken urgently and consultation becomes impossible, the Securities and Markets Stakeholder Group shall be informed as soon as possible.

The Securities and Markets Stakeholder Group shall meet at least four times a year.

2. The Securities and Markets Stakeholder Group shall be composed of 30 members, representing in balanced proportions financial market participants operating in the Union, their employees' representatives as well as consumers, users of financial services and representatives of SMEs. At least five of its members shall be independent top-ranking academics. Ten of its members shall represent financial market participants.
3. The members of the Securities and Markets Stakeholder Group shall be appointed by the Board of Supervisors, following proposals from the relevant stakeholders. In making its decision, the Board of Supervisors shall, to the extent possible, ensure an appropriate geographical and gender balance and representation of stakeholders across the Union.
4. The Authority shall provide all necessary information, subject to professional secrecy, as set out in Article 70, and ensure adequate secretarial support for the Securities and Markets Stakeholder Group. Adequate compensation shall be provided to members of the Securities and Markets Stakeholder Group that are representing non-profit organisations, excluding industry representatives. The Securities and Markets Stakeholder Group may establish working groups on technical issues. Members of the Securities and Markets Stakeholder Group shall serve for a period of two-and-a-half years, following which a new selection procedure shall take place.

The members of the Securities and Markets Stakeholder Group may serve two successive terms.

5. The Securities and Markets Stakeholder Group may submit opinions and advice to the Authority on any issue related to the tasks of the Authority with particular focus on the tasks set out in Articles 10 to 16 and Articles 29, 30 and 32.
6. The Securities and Markets Stakeholder Group shall adopt its rules of procedure by a majority of two-thirds of its members.
7. The Authority shall make public the opinions and advice of the Securities and Markets Stakeholder Group and the results of its consultations.

The SMSG has now decided to issue also an annual report, in order to ensure accountability and transparency regarding the Group's delivery against its objectives and its annual Work Programme, and in order to facilitate better understanding of the SMSG's role. This annual report accounts for the activities of the SMSG since its establishment and its first meeting in July 2011 to the last meeting of 2012 (on 23 November 2012).

2. Meetings and members

The Securities and Markets Stakeholder Group was formed following a call for interest from ESMA's predecessor CESR in November 2010.

After a comprehensive selection procedure, the ESMA Board of Supervisors decided on the composition of the SMSG at its meeting in April 2011.

The Group's 30 members were appointed for a period of two and a half years. The SMSG members variously represent financial market participants and their employees, consumers and other retail users of financial services, users of financial services and small and medium enterprises. The Group also includes five academic members.

In 2011, the Group elected Guillaume Prache, a consumer representative, as its Chair. He is supported by two Vice-Chairs - Peter De Proft, a representative of users of financial services, and Judith Hardt, a representative of financial market participants.

The Securities and Markets Stakeholder Group held its inaugural meeting on 21 July 2011. The Group has since met on six occasions in full: meetings were held on 11 October and 22 November in 2011, and on 15-16 February, 26 April, 28 June, 12-13 September in 2012 and on 23 November 2012. In addition the Group met with the ESMA Board of Supervisors on 15 February and 12 September in 2012. The Summary of Conclusions of its meetings can be found at www.esma.europa.eu/smsg

The Chair and vice-Chairs of the SMSG have also established contacts and held meetings with the stakeholder groups of the other two ESAs, the EBA (Banking), as well as the EIOPA (Insurance and Occupational Pensions Stakeholder Groups), in order to inform each other of their work and learn of each other's experiences.

2.1 Members of the SMSG

Chair:

Guillaume Prache, Managing Director, EuroFinuse (the European Federation of Financial Services Users) (“EuroFinuse”)

Vice Chairs:

Judith Hardt, Secretary General, FESE (the Federation of European Securities Exchanges)

Peter De Proft, Director General, EFAMA, (The European Fund and Asset Management Association)

Other members:

Carlos Arenillas, Chairman and CEO, Equilibria Investments SIL.

Sophia Argirova, Vice Chairperson, the Management Board of the Association of Bulgarian Investor Relations Directors /ABIRD

Ludo Bammens, Director European Corporate Affairs, KKR - Kohlberg Kravis Roberts & Co. (London)

Roland Bellegarde, Member of the Management Committee and, Group Executive Vice President & Head of International Listings and European Execution, NYSE Euronext

Angel Berges-Lobera, Professor of Finance, Universidad Autonoma Madrid

Thomas Book, Member of the Executive Boards of Eurex Frankfurt AG, Eurex Zürich AG and Eurex Clearing AG

Pedro Braga da Cruz, Consultant of Companhia Portuguesa de Rating, S.A

Salvatore Bragantini, Advisor to Borsa Italiana (LSE Group)

Zita Ceponyte, President, Lithuanian Consumer Institute

Aleksander Chlopecki, Professor of Law, University of Warsaw

Pierre-Henri Conac, Professor of Commercial and Company Law, University of Luxembourg

Hans van Damme, Vice-Chair, EFRAG Supervisory Board

Sally Dewar, Managing Director, International Regulatory Risk, JP Morgan

Carmine Di Noia, Deputy Director General and Head of Capital Markets and Listed Companies, ASSONIME, the **Association** of the Italian corporations.

Jaroslaw Dominiak, President of the Management Board of the Association of Individual Investors, Stowarzyszenie Inwestorów Indywidualnych



Lars Hille, Member of the Board of Managing Directors, DZ Bank AG (Deutsche Zentral-Genossenschaftsbank)

Anne Holm Rannaleet, Senior adviser, IK Investment Partners Ltd.

Jesper Lau Hansen, Professor of Law, University of Copenhagen

Sari Lounasmeri, CEO, Finnish Foundation for Share Promotion

Dorothea Mohn, Policy Officer for Pension Schemes and Capital Investment, Federation of German Consumer Organization

Niamh Moloney, Professor of Financial Markets Law, Law Department, London School of Economics and Political Science

Katerina Papageorgiou, Attorney-at-Law, Deutsche Bank AG

Jean-Pierre Pinatton, Chairman of the Supervisory Board, Oddo & Cie Group

Xavier Rolet, Member LSE Group Board and CEO, London Stock Exchange

Adriana Tanasoiu, Chief Executive Officer, Depozitarul Central (Romanian Central Securities Depository)

Tjalling Wiersma, Head of legal & Compliance, Shell Asset Management Company

Gabriele Zgubic, Head of Department of Consumer Policy, Austrian Federal Chamber of Labour

2.2 The Working Groups of the SMSG

The SMSG has set up the following working groups, to undertake the work described above. The working groups have been led by the following members.

AIFMD - **Peter De Proft**

Credit Rating Agencies - **Carmine di Noia**

EMIR - **Thomas Book**

Exchange-traded funds - **Roland Bellegarde**

High-Frequency Trading - **Roland Bellegarde** and **Adriana Tanasiou**

Investor protection - **Guillaume Prache**

MiFID investor protection and intermediaries - **Pierre-Henri Conac**

Short-selling - **Roland Bellegarde**

Prospectuses - **Niamh Moloney**

Proxy voting - **Jesper Lau Hansen**

Shadow Banking - **Peter De Proft** and **Ludo Bammens**

Small and Medium-sized Enterprises (SME) - **Judith Hardt** and **Anne Holm Rannaleet**

To the extent that final advice has been given on a topic to ESMA from the SMSG, the working group ceases to function. On on-going matters like SME, CRAs and Investor Protection issues the working groups in question have a permanent mandate.

3. SMSG one year on – topics, tasks and achievements

SMSG's first year of operation was marked by intense activity, devoted firstly to the development of comprehensive Rules of Procedures, and secondly to the development a number of advice and position papers as outlined in detail below.

3.1 Rules of Procedure

In 2011 the Group firstly developed its comprehensive Rules of Procedure. The Rules of Procedure spell out the precisely agreed rules for approval of SMSG's advice and opinions, including with respect to decision-making, the use of written procedures, and attendance requirements.

It has proved valuable for the group to invest time and work on the Rules of Procedure in order to have a stable basis for its on-going work. The Group believes that the end result presents a well-balanced document that is indispensable for the SMSG in order to be able to work efficiently.

3.2 Prospectus Directive comments

The Group provided comments from the Prospectus Working Group concerning ESMA's 15 June 2011 Consultation Paper on ESMA's Technical Advice on possible delegated acts concerning the Prospectus Directive as amended by Directive 2010/73/EU. The Prospectus Directive comments were not published, given time constraints which prevented the adoption of a formal SMSG opinion, but were instead given to ESMA as individual inputs from the Working Group.

3.3 AIMD - Supervision and Third Countries

The Group adopted in October 2011 its first formal advice paper related to ESMA's draft technical advice to the EC regarding possible implementing measures of the Alternative Investment Fund Managers Directive (AIFMD) in relation to third countries.

The SMSG was appreciative of the large amount of work conducted within a compressed timeframe that ESMA had conducted.

The SMSG focused in its analysis of the draft ESMA advice on how it contributes to achieving the main purposes of the AIFM directive: anticipate systemic risk and provide the appropriate level of investor protection. The SMSG considered in its reply whether these main purposes objectives were achieved in a fit for purpose manner, wherever possible minimizing market impact. This should also allow the right level of tailoring and proportionality for the fundamental diversity and divergence in nature, scale and complexity of the different product offerings to those investors whilst also offering them the protection provided by the AIFM directive.

The SMSG acknowledged the highly valuable work of ESMA and supported its overall approach of the AIFMD, but also called for a consideration of a number of specific elements of the draft ESMA advice. Consideration by ESMA should lead to a better balance between market stability and investor protection on the one hand and proportionality and diversity of investment opportunities offered to European investors on the other hand. There were some elements in the Draft Advice that could potentially impact this balance, in particular where certain proposals can appear not to be strictly aligned with the purposes of the AIFM directive, such as more specifically the proposals around (i) the use of equivalence for third country purposes and (ii) the operating conditions regarding risk management, due diligence or internal organizational requirements for managers.

3.4 HFT - Automated Trading

The Group issued in October 2011 a position paper regarding ESMA's Consultation on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities.

The SMSG noted the importance of placing the key issues around high frequency trading (HFT) in the wider context.

The paper aimed at representing the position of the group and on occasion also included the diverging opinions of its members. The impact of HFT gave rise to heated debates also among members of the Stakeholder Group. Some members of the Group consider that the increased prevalence of HFT was a worrying signal for the stability of Europe's capital markets and strongly recommend that its impact be studied decisively.

The Group noted in the paper that the rise of HFT has been driven mainly:

- By opening the trading landscape to competition, which has led to a greater fragmentation of volumes across trading venues, favouring the emergence of arbitrage strategies;
- By a lack of proper regulation and supervision of the so-called highly automated trading environment;
- By the fact that certain trading venues have accepted excessive transaction speeds while having failed to introduce limitations, in the form of higher costs for example, to the number of orders that can be introduced in a certain period of time;
- By the perverse effect brought about by competition among different trading venues. This increased competition has contributed to the use of activities such as HFT.

In the paper the Group expressed the view that it overall believes that competition is essential to markets, and therefore fragmentation is here to stay, and that technology will continue to adapt to this increasingly complex trading environment. However, the Group also noted that regulation should address some of the risks associated with the increase in HFT, in order to ensure a level playing field and ultimately to better protect the investors. It therefore subscribed to the efforts of ESMA to provide guidelines on safe-guards and controls in a proactive manner, in order to set a framework and pave the way further for European regulation, especially in regards to the Markets in Financial Instruments Directive (MiFID) and the Market Abuse Directive (MAD).

3.5 UCITS ETF

In December 2011 SMSG gave advice on ESMA's public consultation on UCITS Exchange-traded funds (ETFs) in the European Union.

The Group generally agreed with the concerns raised by ESMA in its Consultation Paper, relating mainly to the fact that ETFs have become increasingly complex, and may raise significant issues both in respect to investor protection and to systemic risk.

The Group noted that ETFs are a low cost and straightforward investment proposition for investors, and as such, ESMA should investigate how to make indexed ETFs more offered to retail investors. With respect to the prevention and mitigation of the risks that may arise from ETFs, while the whole Group agreed that greater disclosures are required, the majority of the Group members believed that, in addition to these disclosure requirements, regulators should adopt a more interventionist approach. The Group also noted in the paper that it is necessary to avoid any type of regulatory arbitrage, by subjecting all UCITS products and exchange-traded products to similar rules.

The Group generally supported the recommendations made by ESMA, and agreed that:

- UCITS ETFs should use an identifier in their titles, fund rules, Key Investor Document, prospectus and marketing material;
- investors should be provided with sufficient details to understand the index tracking policy used;
- there is a need for greater disclosures in respect to synthetic ETFs, notably in relation to underlying exposure, counterparty(ies) and the portfolio fund, as well as for stricter requirements in respect to the quality of the collateral, in the form of quantitative requirements on the quality (notably the liquidity) of the collateral, over-collateralisation requirements in specific circumstances, the regulators (and potentially ESMA) being responsible for regularly controlling the quality of the collateral. In addition, risks of conflicts of interests should be limited by prohibiting entities from the same group from acting at the same time as the ETF provider and the derivative counterparty;
- securities lending should be made more transparent to investors, should be forbidden in respect to the collateral received in exchange for the swap in the case of synthetic ETFs, and the lending agent must be required to indemnify the UCITS when a counterparty defaults for all types of ETFs (synthetic and physical);
- actively-managed UCITS ETFs should be subject to greater disclosure requirements;
- it is necessary to specify, in the product title of leveraged UCITS ETFs, that they constitute leveraged ETFs, as well as the level of leverage;
- greater protection of secondary investors would be achieved by informing investors of their redemption rights, the ETF manager being made responsible for paying the difference between the collateral and the index underlying the swap if a counterparty defaults;
- total return swaps and strategy indices need to be better regulated.

3.6 Guidelines on certain aspects of the MiFID Suitability Requirements

In February 2012 the SMSG provided advice to ESMA on Guidelines regarding certain aspects of MiFID suitability requirements.

The SMSG noted in its advice that there is a particular need for protection of clients in the discretionary advice context. In the case of portfolio management services, this protection implies not just that the client “understands the overall risks of the portfolio and possesses a general understanding of the risks linked to each type of financial instrument that can be included in the portfolio” but that the investment firm also gains a very “clear understanding” and an “in-depth knowledge” of the profile of the client, of the client’s background and of the client’s investment strategy.

With respect to the “suitability” assessment, the Group noted in its advice that the concept of risk is very abstract and is, too often, subject to underestimation by investors and investment firms alike. The Group noted that the capacity of an investor to bear a permanent loss should be used instead (or at least to a similar extent) by investment firms. The loss-sustaining capacity of the investor should be considered carefully, and in a practical manner.

The SMSG further noted that:

- The age of the investor should be given more importance in view of recent major cases of mis-selling to elderly retail investors;
- The Guidelines need to emphasise that investment firms consider whether non-tradable products, and particularly basic deposit products, can satisfy the suitability requirement, depending on the particular circumstances;
- Conflict of interest risk is particularly acute when investments are recommended or a portfolio is managed; The Group therefore suggested that the Guidelines provide a more explicit explanation as to how conflicts of interest should be prevented.

3.7 Guidelines on certain aspects of the MiFID Compliance Function requirements

Also in February 2012 the Group gave its advice regarding MiFID Compliance function requirements.

The Stakeholder Group supported the adoption of guidelines related to MiFID and the overall approach of ESMA with respect to the Guidelines on compliance reporting requirements, noting that the issue is of high importance to ensure that rules designed to protect investors are effectively applied and do not remain « law on the books ». Therefore the adoption of the Guidelines should contribute effectively to enhance consumer protection, which is one of the ESMA’s objectives.

The Group noted that while strongly supporting both the timing and the content of the Guidelines, the Group would like to call the attention of ESMA to a number of specific elements. In addition, the Group strongly supports the proportionality principle, which is included in Article 6 of the MiFID Implementing Directive, and even thinks that it should be strengthened.

In general, because of the high costs involved with compliance function requirements, the Group found that that:

- ESMA should be mindful of the costs resulting from the proposed requirements. Therefore, some requirements included in the Guidelines, such as reports, staff-training and expertise should be adapted in order not to prevent investment firms, and especially subject small and medium-sized ones from entering the market and to compete with larger firms;
- Should allow more flexibility for small and medium-sized investment firms.

The Group insisted however that irrespective of the size of the firm, the compliance function has to be performed adequately as the size of the firm is no excuse for poor compliance performance and outsourcing should be required when a firm does not have the resources to perform it internally.

As to the criteria used in the Guidelines, the Group noted that compliance is only a function of the nature of activities and instruments and staff headcount should not be used as a justification for not having an adequate compliance function.

3.8 ESMA's Discussion Paper on Proxy Advisors

In April 2012 the Group provided its advice on a discussion paper on Proxy Advisors that ESMA had issued in March.

The Group noted in its advice to ESMA that proxy advice is mostly relied upon by professional investors, notably institutional investors and that advice is typically provided by a few Proxy Advisors (PA), who operate cross border. In the opinion of the SMSG, PAs should be subject to regulation that ensures their integrity and the quality of their advice and that regulation should establish minimum standards applicable throughout the Union. At this point in the development of EU law, a sufficient and proper measure would be to include these standards in a Code of Conduct (CoC) for PAs adopted in the form of ESMA guidance under Article 16 of the ESMA Regulation (EU) No 1095/2010, directed to national competent authorities (CAs) to ensure that their regulation on PAs involves a uniform approach that observes these minimum standards.

The Group found that it is not necessary to introduce an authorisation regime for PAs at Union level. Rather, it is sufficient that the industry observe the minimum standards of the CoC on a comply-or-explain basis monitored by CAs and that those standards apply to all parties that engage in proxy advice on a professional basis.

Furthermore, National CAs should register PAs and this information should be communicated to ESMA and made available by ESMA to allow continued monitoring and transparency of the industry at a European Union level.

The Group also took the position in its advice that the issues to be addressed by the CoC should reflect the difference between advice that is offered in a non-public way by the PA to its clients, and advice that is made public by the PA. It should also reflect the fact that some PAs offer their advice on a professional basis as their main business activity, whereas other PAs may operate as non-profit organisations that only offer advice as an auxiliary service. It is important that the standards do not create unreasonable fixed

costs that may hamper competition by disadvantaging new entrants. Guidance for proper conduct can be derived from present EU law and initiatives taken by IOSCO in respect of credit rating agencies.

Furthermore, the SMSG noted that the market abuse regime set out in the MAD must inform the CoC to avoid inappropriate behaviour by PAs.

The opinion of the Group pointed to issues that may form part of a CoC, notably on the integrity of the PA, the quality of advice and the level of transparency necessary when giving advice.

3.9 ESMA's draft technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps ((EC) No 236/2012)

In April 2012 the Group gave its comments on the public consultation on the draft technical advice on possible Delegated Acts concerning the regulation on short selling and certain aspects of credit default swaps (hereafter “the Regulation”).

The Group noted in its advice that the adapted Delegated Acts and their efficient enforcement are crucial to meet the goals of the Regulation, namely to address the risks associated with short selling while not undermining the benefits associated with this practice, in order to ensure a high level of investor protection and to protect the integrity of European financial markets. The Group identified in the paper the issues it considered most important in the consultations held by ESMA.

The Group generally supported ESMA’s proposed Delegated acts and Draft technical standards. The clear definition of what is meant by “owning” or “holding” a financial instrument for the purpose of the Regulation is crucial, as well as the setting of clear methods in respect to the calculation of net short positions. However, the Group was concerned by some of ESMA’s proposals. Notably, the Group believes that a “third party” and the legal person entering into a short sale, should not necessarily be required to be part of different legal entities for the purpose of the “locate rule”, as long as the proper Chinese walls and procedures have been put in place. In addition, the majority of the Group members expressed the view that the location (geographical origin) of a financial instrument is only one criterion to be used to determine its correlation with a sovereign debt risk for the purpose of determining whether a financial instrument is held for the purpose of hedging against sovereign risk. In addition, the Group believed that the calculation of a “significant fall in value” should not be based on MiFID’s definition of liquid shares, for illiquid shares, and that it should be based, for bonds, on a combination of a minimum change in percentage yield in conjunction with a minimum absolute change in yield values. Finally, the Group gave its view that the suggestions in respect to price movements are appropriate as long as these do not automatically trigger a suspension of short selling.

The SMSG has also – through its short selling working group - in early October 2012 provided input to ESMA on its consultation on exemption for market making activities and primary market operations under Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of Credit Default Swaps. This reply of the SMSG was produced within a very short time-frame due to the brief consultation period, and was formally not labelled as advice of the SMSG. It has not been published.

3.10 ESMA's Discussion paper on Key concepts of the AIFMD and types of AIFM – Opinion of the SMSG

In April 2012 the SMSG commented to ESMA on the ESMA Discussion paper on key concepts in the AIFMD on a few key points as outlined below.

The SMSG noted in the paper that key elements of the AIF definition in the view of the working group are:

- the raising of capital from external, unaffiliated third parties;
- it needs to be an enterprise with a commercial reason of generating profits for investors;
- there needs to be a business communication by or behalf of the entity seeking capital which results in the transfer of cash or assets to the AIF;
- there should be an express linking of the capital raising with the defined investment policy;
- the capital raising should be done by or on behalf of a "sponsor" which plans (itself or through a group member) to make a profit out of the management of the capital raised from third party/external sources.

The SMSG also noted that proportionality needs to be applied to all articles and not only some, as proportionality is a general principle of law and regulation. It must also be borne in mind that size is not the only relevant factor – others mentioned already in the Level1 text are, nature, scope and the complexity of activities as well as internal organisation.

The SMSG gave the view that regarding dual registration that due to the high number of managers which are currently MIFID firms (in particular for carrying out reception and transmission of orders and investment advice) the possibility of dual registration needs to be considered. Otherwise firms in some member states (where MIFID authorisation is demanded today) may need to restructure their activities while firms in other MS (where MIFID authorisation currently is not demanded) need not.

The SMSG also remarked regarding delegation that it should be clarified by ESMA: Firstly, just because an AIFM itself does not perform certain of the functions in paragraph 2 of Annex 1 of the AIFMD, it does not automatically imply that they should be considered as delegated as these are not mandatory functions to be performed by an AIFM nor are they functions for which an AIFM needs to have responsibility.

Secondly, an AIFM must be able to delegate both portfolio management and risk management as long as the delegation is not to such an extent that the AIFM becomes a letter-box-entity.

3.11 ESMA's public consultation on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories- EMIR

In June 2012 the SMSG provided advice to ESMA on its public consultation on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories, with the objective to provide advice to ESMA on the definition of technical standards and to contribute to achieving the original goals of the financial reforms envisioned by the G20 mandate and the Regulation on OTC Derivatives, CCPs and Trade Repositories ("EMIR"). Recalling the G20's original goals, the Securities and Markets Stakeholder Group ("SMSG") stated that it believes that technical standards should help to achieve those financial reforms objectives, being: Reducing systemic risk through central clearing, ensuring the resilience and safety of Central Counterparties ("CCPs"), strengthening bilateral collateral arrangements, increasing transparency through trade repositories and trading on organized venues and preventing market abuse. The SMSG Advice Paper focuses on topics revolving around EMIR technical standards.

Given the scope defined above, the key messages the SMSG highlighted to ESMA for consideration in their work going forward regarding drafting EMIR (regulatory) technical standards were:

- Technical Standards should be criteria-based and leave flexibility for market-driven approaches;
- New requirements should be phased-in to reduce impact and implementation effort for market participants;
- Clearing obligation for OTC derivatives has to be based on clear definitions to ensure legal certainty
- Information requirements for the clearing obligation are disproportionate and not in-line with the approach taken in other jurisdictions for example by the Commodity Futures Trading Commission ("CFTC") in the US;
- ESMA should focus on harmonisation of CCP requirements in Europe and ensure the consistent application and enforcement of EMIR standards in Europe;
- Ensure international consistency based on principles published by the Committee on Payment and Settlement Systems ("CPSS") and the International Organization of Securities Commissions ("IOSCO") and mutual recognition of European standards by foreign regulators;
- CCP Access Criteria for participation should be further strengthened;
- Default procedures for CCPs require harmonisation of National Insolvency Regimes.

Further the SMSG has provided ESMA with further technical advice in August 2012 on the draft technical standards on OTC derivatives, CCPs and Trade repositories (EMIR).

The SMSG noted in this advice that ESMA and the ESAs should always bear in mind that an increase in capital, whilst increasing systemic resilience and thereby being of benefit to investors and other market users, will undoubtedly result in additional costs and these additional costs will inevitably be passed on to users. This has a bearing on the ability of issuers, particularly small caps, to raise funds in the market; if the overall costs of clearing are so high as to act as a disincentive for investors and market participants to engage in the trading that is required to provide liquidity that keeps the cost of capital lower, such issuers

will find it harder to raise the much needed capital for stimulating growth and rebuilding the European economy at this difficult time.

3.12 Investor Protection

The SMSG has formed a working group on investor protection as an own initiative project in order to take on investor protection issues using a horizontal approach addressing investor protection concerns in relation to all the various aspects of work which the SMSG gives advice on.

The SMSG has encouraged ESMA to make use of its new powers regarding investor protection concerns, notably related to the possibility to make use of Article 17 of the ESMA Regulation, which gives the SMSG the power to ask ESMA to investigate potential breaches or cases of non-implementation of union law.

With reference to its advice to ESMA on ESMA's public consultation on UCITS Exchange-traded funds in the European Union, in December 2011 (above) the SMSG requested that ESMA investigate the retail distribution of index ETFs in several Member States.

3.13 Small and Medium Sized Companies

In February 2012, ESMA's Board of Supervisors (BOS) requested the Securities Markets Stakeholder Group (SMSG) to present its views on the impact of regulation on Small and Medium Size Enterprises' (SME) ability to access funding. The SMSG responded to the BOS' request by setting up a dedicated working group and by agreeing on a mandate. The work of the group is targeted at ESMA but might also be relevant for other European Supervisory Authorities (ESAs). The Group has prepared a working paper for September 2012 which is available on the SMSG website¹.

The Group has in mind when using the acronym SMEs, a much broader group of small and medium sized companies than those confined in the EU Commission SME definition. This is because the original definition used by the EU Commission was set up in the context of state aid and as such is thus very restrictive on e.g. size. The more recent use of this definition also in other contexts has some negative implications on SMEs.

The SMSG considers in its advice SMEs to be companies having a market capitalization/enterprise value below €500 million.

The paper begins with a disturbing diagnosis: though SMEs account for two-thirds of total employment in the OECD countries, two-thirds of entrepreneurs perceive that it is difficult for young entrepreneurs to access financing.

The paper subsequently analyses the regulatory initiatives that impact the ability of SMEs to have access to funding. The paper concludes that regulatory initiatives often have a negative impact on the ability of SMEs to access funding. For example, with regard to private equity and venture capital, AIFMD² will imply

¹ See <http://www.esma.europa.eu/system/files/2012-smsg-59.pdf>

² Alternative Investment Fund Managers Directive (AIFMD) |

increased administration and reporting for SMEs and could affect their cost of capital. The implementation of the Solvency II Directive as well as the Capital Requirement Directive (CRD IV) will reduce the availability of investable capital for private equity and venture capital funds and thus onward flows to SMEs. The AIFMD and the proposed European Venture Capital Funds Regulation (EVCFR) and Social Entrepreneurship Funds (EuSEF) Regimes³, aim to provide an EU-wide marketing passport to qualifying funds thereby enabling more investors to indirectly invest into SMEs. However, on balance, it remains to be seen if the benefits outweigh the costs.

With regard to Regulated Markets and MTF⁴s, the increased transparency following the adoption of MiFID⁵ represents a challenge for SMEs, resulting in a suboptimal time allocation for SMEs' board and management and increased costs for accessing public markets. In addition, MiFID has also heightened the pressures faced by small and medium sized intermediaries with respect to their cost base. The latter were traditionally providing research activities and listing services to the SME sector. A decrease in the amount of research available for SMEs has negatively affected the liquidity of these shares on public markets. There is a risk that regulation extending to 'traditional' MTFs under the review of MiFID/MiFIR and MAD/MAR, may prove burdensome and not appropriate for SMEs. On the other hand, a level playing field is needed between MTFs and Regulated Markets, especially considering that both types of venues are now comparable in terms of trading volumes.

The paper then focuses on regulatory initiatives which impact the ability of investors to invest in SMEs. As a result of CRD III and Solvency II and the uncertainty they bring to investors, there is a decrease of investment flows from banks and insurance companies to equities in general as well as to private equity and venture capital funds. If pension funds covered by IORPD⁶ would also have to comply with Solvency II type of risk weightings, they will be required to hold additional liquid assets. This will not only have a negative impact on pension funds' ability to invest into equity and other long-term assets, but may over time lead to companies being faced with increased costs for pension benefits, as pension funds find it difficult to generate the necessary long-term returns to match their long-term liabilities.

With regard to Regulated Markets and MTFs, creating an SME market regime within MiFID II is a first step towards helping growing companies' access capital markets by gaining profile with the investor community within a European framework. The separate and distinct framework would allow for additional EU measures to increase investors' access to SMEs for example through Solvency II.

And last but not least, the paper sets out a number of policy recommendations cutting across a number of different policymaking areas, both at an EU level as well as at a national level. The SMSG is conscious that some of our proposals are clearly out of ESMA's remit, but we have deliberately chosen to take a broad perspective and holistic approach in our attempt to identify factors critical to the financing of SMEs and which address both the concerns of investors as well as the SMEs themselves.

3.14 Shadow Banking

In mid-2012, the SMSG has decided to set up a working group on shadow banking (or rather non-bank lending) in order to advise ESMA on these matters. The working group has held meetings in the form of

³ These regimes are currently being negotiated in the Trilogues.

⁴ Multilateral Trading Facility (or MTF) is a specific type of European financial trading system.

⁵ Markets in Financial Instruments Directive (MiFID)

⁶ Institutions for Occupational Retirement Provision Directive (IORPD)

telephone conferences in autumn 2012 and has produced informal feedback to ESMA on possible future work in the area of Money Market Funds. The working group aims at finalising a work on non-bank lending in the course of autumn 2012.

3.15 Credit Rating Agencies

The SMSG has set up a Credit Rating Agencies working group in order to follow ESMA's work in this area, both with regard to policy proposals and with respect to ESMA's supervisory activities. In particular, CRA III is expected to require ESMA to produce technical advice and propose technical standards, on which the SMGG will prepare advice. The working group held a presentation on some issues on Credit Rating Agencies at the SMSG meeting in June 2012.

3.16 MiFID Remuneration

In November 2012 the SMSG provided advice to ESMA on Guidelines on remuneration policies and practices (MiFID). The SMSG supported the adoption of the Guidelines and the overall approach of ESMA. The SMSG was of the view that the content of the Guidelines was excellent and that they constituted a timely development as there had been many cases of mis-selling across Europe in the last decade.

While overall approving of both the timing and the content of the Guidelines, which covered, in its opinion, all relevant aspects of this issue, the SMSG further noted that:

- the issue of mis-selling is not limited to questions of remuneration policies and practices. In particular, the SMSG highlighted the specific conflict of interests which arise when financial institutions are selling their own shares or other financial instruments (preferred shares, hybrid securities and or debt) to their own clients (self-placements);
- what constitute an « appropriate balance » is better left for financial firms to decide, subject to the list of bad practices included in the Guidelines. The SMSG did not support the introduction of precise caps in percentage between fix and variable remuneration or of a cap in absolute number in variable remuneration;
- 100% variable remuneration structures, usually linked to tied agents, creates a significantly higher risk of mis-selling. It should, therefore, be subject to enhanced scrutiny by regulators;
- non- financial (qualitative criteria), and not only quantitative criteria should be used in the determination of variable remuneration policies and practices and in the assessment of the performance of relevant persons. The SMSG recommended that qualitative criteria should be a significant part of the assessment;
- the importance of enforcement in this area makes it necessary for supervisors which find evidence of poor practice in breach of MiFID to follow with enforcement action;
- firms should address the potential conflict of interest of sales managers if they are allowed to play a significant role in the business quality monitoring of their own sales staff;

- proportionality has no place in the area of mis-selling. Although the concept of proportionality is not just related to size, but also needs to reflect the sector, the strategy, etc, the fact that a firm is small should not in itself be an excuse for poor remuneration and related selling practices.