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Asset management – The regulatory challenges ahead

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Ladies and Gentlemen,

It is very good to be back again at this important event. Before coming here today I had the chance to surf the EFAMA website and it struck me that your website is as overrun as ESMA's website is with the many well-known European acronyms that have become part of our standard vocabulary in financial markets. This observation also made it clear to me that the topics that keep both our organisations busy are very similar.

Given the current activities of ESMA, you probably expect me to structure my contribution according to these acronyms and inform you on all of our current regulatory work that is relevant for the asset management sector. However, I would like to start first with an economic perspective on asset management, but let me assure you that later in my contribution I will not disappoint you and will refer to AIFMD, MIFID, UCITS and PRIIPs.

The economic perspective of risks in asset management has recently attracted the attention of a broad range of policy makers and regulators in financial markets, and two main risks are identified. The first concerns the potential stability risks the asset management sector poses to the functioning of the broader financial system. The initial analyses focused on the possible stability risks of large individual asset managers but rightly this focus has shifted towards the stability risks embedded in certain activities and practices in asset management.

I very much support this shift as it better takes into account the specific characteristics of the asset management sector. This activity-based perspective is also reflected in ESMA's approach, for example with our guidelines regarding securities financing activities by UCITS funds, which apply regardless of their size. Let me be clear, the stability risks in asset management are not necessarily lower than in other parts of the financial system. However, we need to address those risks taking the specific characteristics of asset management into account.

The second main risk in asset management is related to the unusual current economic environment with extremely low interest rates. These low interest rates have resulted in so-called search-for-yield behaviour and a compression of yields across high and low risk investments. In more mundane words, there is an increasing risk of overvaluation of shares and bonds in asset management. There is a widening gap between the ever increasing valuations and the very weak underlying economic fundamentals. While all involved – investors, industry and regulators – should try to reduce these risks as much as possible, we should also recognise that they are difficult to control. With extremely low interest rates, investors are inevitably less disciplined in their assessments of the risks attached to investments. It is the negative side-effect of the medicine used to cure problems in other parts of our financial system.

Let me now move from the risks to opportunities. Many policy makers and regulators have raised the desirability of moving in the EU from a bank-dominated financial system to a system with more diverse sources of funding. The thinking behind this shift is very attractive: as we all know in asset management, diversity should reduce risks. Also, in the non-banking sector there are more opportunities for equity funding which helps in increasing investments without necessarily increasing the indebtedness of our economy.

The introduction of the term Capital Markets Union has become the catalyst for developing the non-banking sector. A precise description is not yet available: the Capital Markets Union (CMU) is a concept under construction. However, the first sketches are in the direction of an accelerated integration of EU capital markets encompassing all 28 Member States. This integration process already started in the 70s with the first Directives relevant for financial markets. While a lot has been achieved, capital markets in the EU are still fragmented. Needless to say that, as the EU securities markets authority, ESMA is very willing to contribute to achieving a truly integrated capital market and the development of the CMU.

Let me now move to ESMA's regulatory work of relevance to the asset management sector. However, before I do that let me make clear that I see a very strong link between the economic and regulatory perspective of financial markets. Recovering from a deep financial crisis, which resulted in a systematically lower economic growth path, it should be self-evident that good regulation and supervision go hand in hand with successful financial markets that contribute to growth. Considering the nature of financial markets, which all concern intangible services, a comprehensive system of rules and supervision is needed to ensure its proper functioning. Let me now dive into the details of this system of rules and talk, inevitably, about AIFMD, MiFID II, UCITS and PRIIPs.

I would like to begin by talking about a topic that has recently attracted a lot of attention and is of great interest for asset managers: the revision of the rules on inducements in MiFID II.

As you know, the Commission asked for ESMA's advice on potential Level 2 measures on MiFID II in April of this year. ESMA subsequently published a Consultation Paper (CP) in May that set out its draft advice.

Our draft advice on inducements provoked a great deal of comment, notably from the asset management industry. Overall ESMA received more than 700 responses (around 16,000 pages) to its consultation on MiFID II. In the investor protection area, the treatment of inducements was the topic that received the most feedback from stakeholders. ESMA has carefully reviewed the feedback received from stakeholders and is currently discussing amendments to be made to the technical advice.

Today, I would like to focus on two important aspects of inducements: the treatment of investment research and the quality enhancement test.

Investment research was discussed in the CP and the focus was not on research in general but on the mechanism, commonly used by industry, which enables portfolio managers to receive research from executing brokers out of dealing commissions.

The legal framework is well-known: MiFID II provides for a general prohibition on investment firms that provide portfolio management and investment advice on an independent basis from accepting and retaining fees, commissions or any monetary or non-monetary benefits.

The only exception to this prohibition concerns minor non-monetary benefits that are capable of enhancing the quality of service provided to a client. They should also be of a scale and nature that do not impair compliance with the investment firm’s duty to act in the best interest of clients and be clearly disclosed to clients.

ESMA’s CP specified, in line with MiFID II, that such benefits should only qualify as minor ones when they are reasonable and proportionate and of such a scale that they are unlikely to influence the recipient’s behaviour in any way that is detrimental to the interest of clients. In line with this approach, the ESMA paper proposed strict limits on the possibility for portfolio managers to receive research out of brokerage commissions.

In particular, ESMA’s proposal was that research which could qualify as a minor non-monetary benefit would be investment research intended for distribution so that it is accessible by a large number of persons or for the public at the same time. This type of research, indeed, clearly could not be judged to impair compliance with the portfolio manager’s duty to act in the best interest of clients.

The majority of respondents considered ESMA’s proposal too strict. A range of arguments were put forward in this regard. Some stakeholders consider that research should not be classified as an inducement, while others emphasised that research is important for the quality of the service provided to clients. Others considered that conflicts of interest requirements are a sufficient safeguard. A number of respondents emphasised the potential unintended consequences that the ESMA proposal could cause in terms of limiting access to research for smaller portfolio managers and coverage of research for SMEs. There was also criticism that ESMA was taking an approach which is not shared at international level.

ESMA is carefully considering the concerns expressed by stakeholders and is currently developing revised technical advice aimed at addressing them, while at the same time complying with the restrictive approach that MiFID II has adopted on the treatment of inducements for portfolio managers.

Let us now move to the quality enhancement test. Supervisory experience and market research demonstrate that important factors can lead to poor advice regarding financial instruments, or more broadly financial products, including conflicts of interest arising due to payments provided to investment firms in relation to the service they provide to clients (so called inducements). These problems cannot be solved just with more transparency with experience showing that this market mechanism does not always work effectively in financial markets, and so regulation and supervision is needed to achieve the right outcomes and to protect investors.

In this respect, besides the specific regime provided for portfolio management and independent advice that I just described, inducements are allowed in other cases subject to meeting disclosure and the following specific requirements: inducements should be designed to enhance the quality of the service to the client (the so-called quality enhancement test) and they should not impair firms' compliance with their overarching obligations to act honestly, fairly and professionally in accordance with the best interests of clients.

ESMA's draft technical advice proposed a list of negative circumstances and situations to be considered in order to determine when the quality enhancement criterion is not met. At the same time, ESMA mentioned some positive circumstances where an inducement could be considered acceptable, notably if it enables the client to receive access to a wider range of suitable financial instruments or the provision of non-independent advice on an on-going basis provided that such service is without bias or distortion as a result of the fee, commission or non-monetary benefit.

The majority of respondents did not agree with the negative list suggested by ESMA. Most respondents focused on investment advice and underlined that MiFID II only bans inducements when independent advice is provided. They therefore argued that the ESMA advice was not in line with the Level 1.

These respondents expressed the concern that ESMA's proposals would reduce access to advice for the typical investor. It was noted that investors are not yet ready to pay an explicit cost for advice and that

ESMA's approach would encourage a situation in which only wealthier investors would or could receive advice.

Other respondents sought clarification on the relationship between the negative and positive situations and circumstances identified in the CP.

I would like to reassure stakeholders that we are very much aware and respectful of the distinction that MiFID II makes between independent and non-independent advice. The objective of the draft advice, in line with the Commission's request, was (and will be) rather to identify situations in which quality enhancement is not fulfilled.

Also in this case, ESMA is carefully considering the concerns of many respondents that the future implementing measures should not have the unintended effect of reducing clients' access to investment advice nor should they discourage the so-called "open architecture" model. Indeed, as a regulator with investor protection as one of its main objectives, I support the need for good advice for retail consumers. However, we should also acknowledge that not all advice is good advice. We do not serve investor protection when advice is distorted by inducements, instead of enhanced by inducements.

Therefore, in keeping with the position I expressed on research, the final ESMA advice will have to comply with the relevant MiFID II requirements and address the concerns that justify the specific regulatory focus on inducements.

I will now move to the topic of UCITS. You will be aware that the European Commission asked ESMA to provide technical advice on the latest incarnation of the Directive, UCITS V. The advice is limited to two issues, namely the safeguards needed to ensure that assets are safe in the case of insolvency of a sub-custodian, and clarification on how the depositary should remain independent from the management company. These are important topics for the UCITS industry and UCITS investors. Many of you will have seen and responded to the consultation on the draft advice that we launched at the end of September. We received more than 60 responses by the deadline of 24 October and are now in the process of finalising the advice with the aim of submitting it to the Commission by the end of November.

Moving on to UCITS more generally, we all recognise that UCITS is a strong and robust regulatory framework, and that it has been extremely successful as an international brand. Going back to my earlier remarks on the relationship between regulation and successful financial markets, UCITS is one of the best examples of how both can go hand in hand. More than 25 years after the first UCITS was created, it is important to look at what has made the framework such a success and what can help to maintain that position in the future. Let me be clear – it is not the role of ESMA, or of regulators generally, to promote particular firms, sectors or products. However, when we know that a product exists that has been carefully developed over a number of years, provides strong protection to retail investors and at the same time happens to be a successful European export, we should do our best as policymakers to foster and encourage that product.

Within the past five years there have been two significant reforms of UCITS: UCITS IV and UCITS V. The former aimed to introduce some additional flexibility for UCITS managers, such as through the management company passport, while improving the quality of pre-contractual disclosures for investors through the Key Investor Information Document (KIID). I will come back to the KIID later in the context of PRIIPs. UCITS V, meanwhile, focused on depositary issues, remuneration and sanctions. There has been much talk of whether there will be a UCITS VI and what it might contain. My own feeling is that many of the more pressing issues that might have called for action on UCITS VI have been or are in the process of being tackled via other measures. Take money market funds as one example – we welcomed the Commission's proposal for a Regulation and are following with interest the developments in the Council and Parliament, which we hope will result in an agreement in the coming months. Another aspect that might have been included in UCITS VI are the issues concerning securities lending, repo and reverse repo activity. In that context, ESMA issued the earlier mentioned guidelines on ETFs and other UCITS issues in 2012.

Taking this into account, I would favour taking some time in the first instance to ensure that the UCITS framework, as amended most recently by UCITS V, is implemented correctly and that national regulators are applying it in a convergent manner. Of course, this does not mean that we should not remain vigilant and that, where we as regulators identify problems, we act to address them. I would venture to suggest, however, that many of the problems that we face at present can be fixed by ensuring that the existing rules are applied properly rather than necessarily introducing new or different requirements.

Let us now move on to the topic of PRIIPs which is a big challenge for the three European Supervisory Authorities (ESAs): it is arguably the most extensive and complex joint work stream that has been tackled by us. It is also the first on which the three ESAs have been tasked with delivering joint technical standards in the investor protection area. Last but not least, the Key Information Document (KID) will be the most tangible output of the ESAs in the eyes of most EU citizens.

The PRIIPs Regulation provides a framework for establishing consistent and high-quality disclosures for retail investors across the financial services sector, which is a crucial element in policymakers' efforts to strengthen investor protection. It will capture investment funds, structured products (including structured deposits) and insurance-based investments. The KID itself, which is limited to three pages in length, cannot be exhaustive. However, the KID has to contain sufficient information to allow consumers to make an informed investment decision and to compare different offerings. That information will have to be presented in an accessible and consumer-friendly way, otherwise investors simply will not read it.

The work on PRIIPs is being carried out through the Joint Committee, which is appropriate given the cross-sectoral nature of this legislation. The Regulation mandates the Joint Committee to develop technical standards on a number of aspects, the most important being the format and content of the KID. The next significant milestone from the ESAs' perspective will be the publication of a discussion paper (DP) which you should see later this month. The DP is the first opportunity for stakeholders to give input to the Joint Committee on this project, but it is important to highlight that it will not be the last. Indeed, between now and the deadline for the delivery of the technical standards around the beginning of 2016, there will be at least two further rounds of consultation, not to mention the many other channels we use in order to gather stakeholder input.

The feedback we get from that process will be complemented by the results of the consumer testing exercise that the European Commission, working closely with the ESAs, will launch very soon. A similar testing exercise was run in the context of the development of the UCITS KID and it was probably the single most important element in arriving at the final policy choices. Given that the KID will be used by millions of consumers across the EU on a daily basis it is only right that consumer input will be a key driver of what the final document looks like.

I mentioned earlier the UCITS KIID that was introduced by the UCITS IV reforms. It is important that the work of the Joint Committee on PRIIPs take due account of what was done in the UCITS context. Indeed, we should not try to reinvent the wheel given that a significant proportion of the PRIIPs industry is already using the UCITS KIID, and investors have become familiar with the content and format of that document. Having said that, we all have to recognise that the PRIIPs initiative covers a much broader range of products than UCITS and that it will not be possible to have exactly the same document as in the past.

Let us leave the retail funds sector and spend a few moments in the alternative space. A lot of ESMA's work in the asset management area in recent years has related to the Alternative Investment Fund Managers Directive (AIFMD). Since I spoke at last year's Forum, there has been significant progress; AIFMD is now transposed in almost all Member States and the framework is really up and running. ESMA's role has shifted accordingly and is now focused on solving issues of divergent interpretation of the requirements, such as on the reporting obligations or the depositary rules.

The next key deliverable for us in the AIFMD context is the opinion and advice to the Commission on whether to extend the passport to non-EU AIFMs and AIFs. Although our input to the Commission is not due until July 2015, this is a substantial piece of work that we already launched several months ago. At the moment we are primarily in an information-gathering phase. In particular, we are collecting data from the national regulators on the functioning of the EU passport and the national private placement regimes, through which non-EU entities can get access to the markets of the individual Member States. The data relates not only to the extent to which these two mechanisms are being used, but also to more qualitative aspects such as whether investor protection issues have arisen or problems of supervisory cooperation have been detected. This information will be crucial in helping us make our assessment of the current arrangements and, subsequently, whether we feel that the passport can be extended to entities outside the EU.

I would like to highlight a couple of points in this context. The first is that our advice will not treat all non-EU countries as a single block. In other words, we will not simply say “yes, there should be a passport for everyone”. Rather, we will distinguish between the various non-EU jurisdictions taking into account the criteria set out in the AIFMD itself. Secondly, one of the aspects that we will look at is whether EU entities experience difficulties in getting access to non-EU markets. This is just one of the criteria to be assessed, but it is an important one.

In order to complement the information that national regulators are providing us, we will shortly launch a call for evidence on this topic. You, like all stakeholders, are invited to give us information that you consider relevant to the opinion and advice.

Let me at the end of my speech move away from our regulatory programme and raise the topic of supervisory convergence. As I already said at last year's Forum, as we are moving in the regulatory reform process from regulation to implementation, supervisory convergence is an increasing priority for ESMA. An important instrument in this area is the so-called peer review where we assess national supervisory practices. To make these reviews more effective, we have worked on our methodology and increased our on-site visits to national regulators as we are convinced that these are needed to get a realistic view of national supervisory practices and how they differ.

I am very happy that I can announce that we are close to finalising the first two peer reviews under our new methodology and their results will be published shortly. They concern topics which are very relevant to the asset management sector: the supervision of conduct of business rules regarding clear, fair and not misleading information and the supervision of the best execution requirement. Without going into any detail now, the results clearly show that there is still a lot of convergence work ahead of us. Progressing on supervisory convergence is viewed by some as emptying the sea with a teaspoon. While indeed, the results of our regulatory work are more visible and tangible, that will not discourage us from stepping up our activities in the convergence area. I am convinced that to achieve a single market for financial services the converged supervision of rules is as important as the rules themselves.

Thank you for your attention.