European Securities and Markets Authority

Date: 24 March 2015
ESMA/2015/620

MIFID/MIFIR- CSD hearing before ECON

Steven Maijoor
Chair

Dear Members of the European Parliament,

Ladies and gentlemen,

I am delighted to have been invited by the Chair and Members of ECON to present the work of ESMA on the delegated acts and implementing measures under MiFID 2/MIFIR and CSDR.

<u>MIFID2/MIFIR</u>

Let me first comment on MIFID2/MIFIR, which is the most significant piece of Level 2 regulation that ESMA has undertaken since its establishment. As you know, part of this undertaking is making every effort to ensure that the consultation is as wide and open as possible and that all stakeholders are heard. We have also updated periodically the Parliament on how the Level 2 measures advanced.

Let me first comment on the Markets area and I will concentrate on three substantive matters (non-equity transparency, commodity derivatives, and microstructure).

Non-equity transparency

As you are well aware, MiFID II introduces a new, ambitious transparency framework applicable to non-equities. For ESMA, the most challenging task we face at the moment is obtaining and analysing the data needed to set the liquidity and transparency thresholds, because of two reasons: 1) these markets are currently not transparent and so the data available is necessarily limited and of varying quality, and 2) the vast scale and resource-intensive nature of the exercise.

One of the elements that has attracted greater attention is transparency for bonds. Since transparency is linked to the notion of liquidity, which is not prevalent in European bond markets, the number of bonds that will be transparent is very small: less than 10%. ESMA proposed a classification of liquidity based on a “class of bonds” concept, built around issuance size. We are aware of the limitations this entails and the concerns it raises both in the sell- and the buy-side and we are in the process of assessing which changes would be needed.

Commodity derivatives

Our work in relation to commodity derivatives is another hive of activity. The EU is going into new, unchartered territory by implementing the most extensive position limits regime in the world. ESMA is mindful of the responsibility it has here to set a methodology which balances a unified approach with sufficient flexibility to avoid stifling markets, particularly illiquid ones, and new contracts.

However, in the commodities world it is not just the instruments themselves which will be subject to new regulation. Commodity firms will have to either curtail some of their ‘speculative’ trading activity or become authorised under MiFID II, since the exemptions they benefited from under MiFID I are substantially narrowed. Consequently, the ancillary activity exemption and the thresholds ESMA will set is the focus of interest. ESMA’s aim, in this regard, is to follow a principle of fairness: the exemption is intended to benefit commercial users and producers of commodities but to capture those firms which undertake pure financial trading that is not related to the hedging of their commercial operations. With that in mind, we will review the thresholds established in the Consultation Paper.

Market Microstructure

In the area of market microstructure, the two “stars” of our proposals are the tick size table and the market making obligations. ESMA started to conduct, quite early in the process, a significant evidence-based analysis of the interactions between the size of the tick, the incidence of HFT, and the efficiency and depth of the market. We have kept three basic principles during this process: 1) that competition between venues should not be based on the size of the tick they apply, 2) that an adequate relation should be found between the tick and the spread of each share, and 3) that both liquidity and price should be relevant for the determination of the tick size. We remain convinced of those principles and we are working on how the proposal could be further improved or fine-tuned.

In relation to market making obligations, it is important to stress that we received the task of developing the details of a regime that brings new obligations for a number of firms that are quoting with algorithms. Inevitably, this will bring big changes to market practices and many stakeholders are aware that their activity will need to adapt accordingly, which is the natural result of Level 1. We have based our proposals on the concept of incentivising market making, not forcing it, when market conditions deteriorate but requiring a minimum significant presence when market conditions are normal.

After covering these three topics, I would like to mention two procedural points.

Flexibility to intervene in the regulatory process

I have already pointed out to this Committee that the Union has rightly adopted the principle of maximum harmonisation on these matters, with a single EU rule enforced by national supervisors. However, when a brand new regime like this comes into place, the regulator needs to be extremely vigilant to monitor the unintended impacts in the first months and years of the new regime and be able to conduct adjustments. However, neither national authorities, nor ESMA have any tool to take quick action should that occur. Therefore, it will be essential that in the first years after the go-live of MiFID II, ESMA and the EU institutions keep a close dialogue and explore the mechanisms to address regulatory adjustments in a flexible and agile manner.

Implementation timing and effort

I would like to finish the Markets area by stressing how huge an effort the post-regulatory phase will require, for everyone involved, including supervisors, market participants and infrastructures. The rules will be final only towards the start of 2016, and there will be just 1 year to put in place IT systems, procedures, templates, databases, formats, and reporting. Although significant resources are being used both in the public and the private sector, it will be a very significant challenge to have all the systems implemented and running by January 3rd of 2017.

Investor Protection

Let me now move to the investor protection side. MiFID II provides a framework that will support investment firms to act in the best interest of their clients, by improving governance and organisational requirements for firms, strengthening conduct of business rules regulating the relationship with all categories of clients, and introducing new powers to supervisors at national and EU level.

ESMA's technical advice sent to the Commission on 19 December last year is in line with these overarching objectives. It proposes to the Commission to adopt several measures that will further contribute to the protection of investors across the European Union. These measures tackle problems which became even more evident during the crisis. Just to mention a few of them: an industry culture not sufficiently oriented to behave in clients' best interest, and insufficient management of situations of conflicts of interest affecting the way services are provided to clients.

The areas covered by ESMA's technical advice aim, therefore, at proposing more granular measures which range from governance and organisational aspects to specific conduct of business obligations. All these measures aim at ensuring better design of products, enhanced services to clients, more complete and clear information about their investments, proper management of conflicts of interest, better assessment of the suitability of products recommended to clients, an improved framework to achieve best execution, strengthened protection of investors' assets and a fair and efficient treatment of their complaints.

I would like to stress that the final technical advice submitted to the Commission was the result of a thorough process of stakeholders' consultation and we think it strikes a delicate balance between different views expressed by a wide range of stakeholders, including representatives of investors and the financial industry.

In parallel with the work on the technical advice and the technical standards required to ESMA, we are also working on guidelines mandated by MiFID II. It is worth mentioning the guidelines on complex products, on knowledge and competence of staff and, jointly with the other ESAs, guidelines on cross-selling, and management bodies.

The common work with the other ESAs brings me to another comment that I consider very relevant in the perspective of investor protection. In particular, I would like to emphasise that, while MiFID II certainly is an important piece of legislation for the protection of investors, it is not the only one. In order to ensure the protection of investors irrespective of the product they buy and to avoid regulatory arbitrage, it is of the utmost importance that the legislative framework regulating different products and sectors is aligned. The adoption of the PRIIPs regulation was an important step in this direction.

CSDR

Let me in the remainder of my contribution talk briefly about CSDR. ESMA has been drafting more than 30 measures under CSDR. Despite the challenging timeline and the complexity of matters at hand, here we have also consulted extensively: we have held two full consultations, received spontaneous input, and discussed all important issues with stakeholders in several roundtables.

We have done this in very close cooperation with central banks. The overall input to our Consultation Paper was quite positive and showed progress from the earlier Discussion Paper. As regards settlement discipline, notably penalties and buy-in, there are still important challenges.

Cash penalties and buy-in are the most difficult topics. They raise complex technical issues and stakeholders provided significant comments to the consultation paper. The main points for buy-in relate to who should execute the buy-in when the transaction is not cleared by a CCP or executed on a trading venue. The CSD? Its participants? The trading counterparties? Level 1 is unfortunately unclear here and leaves to ESMA the definitions of “the details”.

ESMA proposed that the settlement system, being the CSD and participants, should be the framework in which the buy-in should apply. Some CSDs and banks are pushing for the buy-in to be executed at trading level: by the clients, or the clients of the clients, of the participant. They claim, which seems a fair point, that if they face the risk of the cost of the buy-in, they will demand guarantees and collateral to their clients to cover that risk, rendering the system more expensive, which seems contrary to the objective of the Regulation. However, if the launch of the buy-in is left to the discretion of the ultimate clients, who will be in many cases outside the Union and outside the reach of EU supervisors, this will cause obvious enforceability problems which may render the whole buy-in regime inapplicable. ESMA is, therefore, facing here an interesting conundrum, which is our current priority.

Let me finally spend a few words on the main point on penalties raised during the consultation. For illiquid instruments, borrowing costs are not an appropriate indicator to set the penalties, as the instruments are simply not available for borrowing. Therefore, setting a penalty rate on the basis of the borrowing cost may ultimately dis-incentivise trading in those instruments rather than having a deterrent effect on fails, so ESMA is considering this comment and assessing how to best reflect it in its final approach.

Thank you for your attention.